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S. HRG. 103–236

CHALLENGES AND OPPORTUNITIES FOR THE CONDUCT OF MONETARY POLICY

Y 4. B 22/3: S. HRG. 103-236

Challenges and Opportunities for th...

HEARING

BEFORE THE

COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS UNITED STATES SENATE

ONE HUNDRED THIRD CONGRESS

FIRST SESSION

TO EXAMINE THE OUTLOOK FOR INFLATION, GROWTH, AND EMPLOYMENT IN THE U.S. ECONOMY AND TO LOOK AT THE MONETARY OPTIONS THAT SHOULD BE CONSIDERED BY THE FEDERAL RESERVE

JULY 1, 1993

Printed for the use of the Committee on Banking, Housing, and Urban Affairs

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CHALLENGES AND OPPORTUNITIES FOR THE CONDUCT OF MONETARY POLICY

THURSDAY, JULY 1, 1993

U.S. SENATE,
COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS,
Washington, DC.

The committee met at 10:08 a.m., in room SD–538 of the Dirksen Senate Office Building, Senator Paul S. Sarbanes presiding.

OPENING COMMENTS BY SENATOR PAUL S. SARBANES

Senator SARBANES. The committee will come to order.

We're very pleased to welcome this morning to testify, actually, two very extraordinarily able witnesses—one of our country's leading financial analysts, Henry Kaufman, currently president of Henry Kaufman Company, and one of our Nation's leading economists, Paul Samuelson, professor of economics at MIT and recipient of the Nobel Prize for Economics.

The subject of today's hearing is the opportunities and challenges facing the conduct of monetary policy by the Federal Reserve Board.

At the most recent meeting of the Federal Open Market Committee in May, the Open Market committee voted to lean toward higher short-term interest rates. It authorized the chairman of the board to increase the Federal funds rate by as much as one-half percentage point without seeking a vote of the Open Market committee if economic conditions warranted such action.

That has caused considerable concern on the part of many of us. The purpose of this morning's hearing is to examine the outlook for inflation, growth and employment in the U.S. economy and to look at the monetary policy options that should be considered by the Federal Reserve.

Of particular interest to the committee are the implications for monetary policy of the fiscal policy now being developed by the Congress through the budget process. It's clear we're on our way to enacting a major deficit reduction package which, in fiscal terms, is contractionary. Also, the slow growth or recessions now besetting the economies of Europe and Japan.

The committee is interested in the conditions in labor markets, commodity markets, industrial capacity, import competition, and other factors that may affect inflation and the significance, if any, of recent developments of the monetary aggregates.

Next week, the leaders of the major industrial countries will meet in Tokyo to discuss the outlook for world economic growth and the policies that should be followed to promote that growth.

Central to that discussion should be the conduct of monetary policy by the leading central banks, including, of course, the Federal Reserve. That, in my view, is the broad context in which this morning's hearing should be set.

Gentlemen, before we turn to your testimony, Chairman Riegle is here with us and we're very pleased to have him. I yield to the Chairman of the Full Committee.

OPENING STATEMENT OF CHAIRMAN DONALD W. RIEGLE, JR.

The CHAIRMAN. Thank you very much, Senator Sarbanes. Let me commend you for spearheading this effort today.

Let me welcome our two witnesses. They've been here before and always do a great service to this committee and to the country by their presentations and they're work just generally on these large public policy questions.

It's very important that we understand today the appropriate kind of monetary policy that really best fits the economic conditions that we're experiencing. It's been now more than 3 years since the last recession began, but we have not in any meaningful sense fully recovered from it.

In fact, after dramatic revisions, just last month, the estimated number of jobs in the economy finally had gotten back, according to the statisticians, to its pre-recession level.

But with normal growth in the labor force, the unemployment rate has shown very little improvement. At nearly 7 percent, it is barely one-third of the way back to where it was before this long running recession started.

Although the economy showed some strength in the second half of last year, this year's growth has dropped back into a very anemic range. In the first quarter, GDP increased at a scant 0.7 percent on an annual rate basis. Recent data suggests that there was little improvement in the quarter just ended.

Declines to levels below those of late last year were reported earlier this week and leading indicators in consumer confidence and in new home sales, and forecasters have been lowering their growth estimates. Merrill-Lynch, for one, has revised its estimate for last quarter's growth rate to 1.8 percent.

If that turns out to be correct, then meeting the Fed's February projection of 3 to 3¼ percent growth for the year would require roughly a 5 percent growth rate for the next two quarters.

I don't think that's in the cards. In light of the increasing weakness we see in the European and the Japanese economies and the contractionary implications of the budget legislation that we are currently working on, I think such an acceleration in growth is very unlikely.

It is in this context that I think it was surprising to read that Federal Reserve officials are actively considering interest rate increases to restrain the economy and, thus, presumably limit any potential for upward pressure on inflation rates.

Apparently, the alarms that they are setting off come from unexpectedly high inflation reports for the early months of this year. But the more recent reports I think have been much better in that area.

Despite that, the reports of possible Fed tightening have continued, and that's a source of concern to me as well as to Senator Sarbanes.

So today, I think we need to hear from our witnesses where they think our economic risks are the greatest. Are those risks primarily in the area of inadequate growth of incomes and inadequate job creation? Or are we facing some significant inflation threat here that most of us do not see that really needs to be elevated up to a high priority? Is there anything the Fed should be doing now that it is not doing? How responsible should we hold the Fed if growth does not pick up later this year?

Later this month, on July 22, Chairman Greenspan will be testifying here on the Fed's semi-annual monetary policy report. Today's hearing, in conjunction with that upcoming hearing, will help the committee make its assessment of monetary policy.

I finally want to just conclude by observing that I'm not quite sure what we make of the mounting levels of unemployment and economic weakness in Europe, taken as a whole.

Chairman Moynihan of the Finance Committee is, among other things, something of a historian. I asked him the other day when the last time was we had seen this kind of economic distress on such a broad footing in Europe.

His off-the-cuff answer was you really had to go back to the 1930's to start to see the kind of high-level, sort of broad unemployment that we're seeing there now.

I'm concerned about that. I'm concerned about how quickly it can turn around, especially because we're going through all of the adjustment issues with respect to the collapse of the old Soviet Union, the Berlin Wall coming down, all of the efforts to democratize those economic and political systems.

And as we look at the difficulties of working through the adjustments coming off Cold War-driven economies, even here, if we look at the State of California, for example, in terms of the kind of economic distress that's there and the difficulty of dealing with it, I'm concerned about the aggregation of these problems on a global basis. They look to me to be different in kind from other things we've seen in recent history.

So I'd like your feel about that aspect of it. You both are economists of very great note, Professor Samuelson, a Nobel Prize winner, and you've looked at these things over a long period of time.

I'd like to have you try to bring some reflection in on the question of how different and unique are these problems that we have now, amassing on the international side, and how should we view those.

Senator SARBANES. Thank you very much, Chairman Riegle.

Senator Bond.

OPENING STATEMENT OF SENATOR CHRISTOPHER S. BOND

Senator BOND. Thank you very much, Mr. Chairman.

Gentlemen, it's a real pleasure to welcome Dr. Samuelson, Mr. Kaufman. Your opinions are of great value to us. I have read with interest your prepared comments and certainly would agree with you that, with respect to monetary policy, this does not seem to be the time to be tightening up when the economy is still sluggish.

With respect to overall economic policy, I was struck by a survey appearing in yesterday's Wall Street Journal which confirms what I have heard anecdotally, talking to businesses and economic decision-makers, primarily in my State.

The survey conducted by A.T. Carney, Inc., suggests that businesses are continuing to scale back capital spending plans amid the uncertainty and dissatisfaction over the Clinton economic program. Some 85 percent of the chief financial officers surveyed said they were dissatisfied. There's a direct relationship between the fear of the plans and their decisions to spend money, which I think is translating into an economic slowdown in this country, keeping our economy more sluggish.

The businesses are also looking at what has been rumored to be an additional $50 billion to $150 billion tax increase for the health care plan. I believe that that is destroying business confidence, slowing down the needed investment in jobs.

It's clear from talking to retailers that consumer confidence has also been hit by these plans.

We will be very interested to hear your comments. I've had the privilege of reading other writings by both of you and will look forward to how you assess the impact of these plans and their signals for monetary policy, what can and what must be done in that area.

Thank you, Mr. Chairman.

Senator SARBANES. Thank you very much.

Senator Moseley-Braun.

OPENING STATEMENT OF SENATOR CAROL MOSELEY-BRAUN

Senator MOSELEY-BRAUN. Thank you very much, Mr. Chairman. I, too, am delighted to have an opportunity to listen to these witnesses, particularly from Dr. Samuelson. I remember using his book in school as a textbook. So I have familiarized myself already with some of the rudimentary aspects of his perspective.

I don't want to go too far, except I think I have a couple of initial concerns that I would like Professor Samuelson and Mr. Kaufman to address. Those questions go to what would be the appropriate—or what suggestions would they have for the United States representatives at the G–7 meeting that's coming up, in terms of suggestions for monetary policy with the G–7 partners, particularly the Germans.

Everybody has been pushing the Bundesbank to lower rates further as a way of helping stimulate the economy. They seem to still be recalcitrant, although less so than in the last year, earlier in the year.

What suggestions would you suggest that our representatives at the G–7 make with regard to interest rates, monetary policy, specifically, for the Germans and for the British, as well as for the group as a whole.

And then second, whether or not you believe that there is opportunity—to what extent you think the opportunity exists for monetary policy alone to help provide us with the growth that we need to have in this economy.

Certainly, fiscal policy has to play a role. Where would you draw the line? How much would you emphasize of monetary policy vis-

a-vis fiscal policy, as a way of addressing our sluggish economic growth?

And so, those would be my general concerns. If you could address those in your remarks, I'd be delighted to hear and I'm delighted to learn from you this morning.

So, again, Mr. Chairman, I want to thank you for calling this meeting.

Senator SARBANES. Well, thank you very much.

Gentlemen, we'll now proceed to your statements.

Mr. Kaufman, why don't we hear from you, and then we'll go to Professor Samuelson. We appreciate these very comprehensive and thoughtful statements which both of you have submitted to the committee.

Why don't you proceed as you please? Please take whatever time you think you need to make your presentation.

STATEMENT OF HENRY KAUFMAN, PRESIDENT, HENRY KAUFMAN COMPANY, INC., NEW YORK, NY

Mr. KAUFMAN. Well, thank you very much, Mr. Chairman. I am pleased to accept your invitation to give my views on the conduct of monetary policy in the United States. I will try to summarize part of my prepared remarks and highlight a number of others.

Over the most recent cycle, monetary policy, I believe, has had to contend with extraordinary economic and financial circumstances which posed, I think, a lot of challenges to the formulation and the implementation of appropriate policies.

Now the implication of that kind of development is that our central bank no longer has a reliable measuring rod with which to calibrate monetary policy. It has no choice but to rely on judgment rather than a lot of quantitative specific, simplistic measures.

The Federal Reserve presently has considerable latitude to exercise judgment because its credibility has been enhanced by the recent monetary policy accomplishments and I think it's important to note what these are, and let me briefly summarize them for you.

First of all, interest rates have been lowered significantly. By the beginning of this week, the yield on the 30-year U.S. Treasury obligation, for example, which is the bellwether for the U.S. fixed income markets, fellow below 6¾ percent, from 9 percent back in 1989, and 8¼ percent in April, 1991.

Now, to be sure, this decline in short-term rates exceeded that of intermediate and long-term rates by a very large margin, producing what is called an exceptionally steep, positively sloped yield curve.

But that positively sloped yield curve has provided considerable benefits to the American economy and to the financial system; specifically, it's helped the financial institutions to rehabilitate themselves, such as banks, savings and loan associations, and other financial institutions which had suffered enormously from a variety of things.

Second, gradual declines in interest rates across the entire maturity spectrum have been supportive of large-scale bond issuance by corporations, by financial institutions, and by State and local governments. This has permitted the refinancing of higher-cost existing debt, thereby lowering interest rate expenses.

Third, lower interest rates have been conducive, as you know, to a record amount of refinancing of existing mortgages. This has allowed millions of homeowners to improve their financial position through a combination of lower interest rate payments and faster repayment of mortgage principal.

And fourth, the Federal Reserve has encouraged the downward trend in long-term interest rates more directly through useful modifications in the technical aspect of the Open Market operations.

Specifically, from time to time over the past couple of years, the Federal Reserve has added permanent reserves to the banking system by acquiring sizable amount of U.S. Treasury coupon issues. That is, obligations with a maturity in excess of one year, instead of just purchasing Treasury bills.

As I show in my detailed testimony, the Federal Reserve bought just $14 billion of U.S. Government obligations in 1990, of which 93 percent were Treasury bills and only 7 percent were longer-dated obligations. But in 1991, and in 1992, these purchases rose to $31 billion per year, and in 1992, some 65 percent consisted of coupon issues; that is, of longer-dated obligations.

Especially noteworthy has been the sharp increase in the takedown of governments with a maturity of over 5 years, an increase that has accelerated this year.

Now it also ought to be noted that the new financing initiatives undertaken by the U.S. Treasury this year will, I believe, help to promote lower long-term interest rates in the United States. The Treasury has reduced the magnitude of new issuance of long-term bonds and has announced that it will cut back substantially on future 30-year bond issues by moving to 2 yearly auctions from four auctions a year.

This policy kind of change, which I have long favored, not so much because it will reduce the Treasury's overall borrowing costs, but because it will open up opportunities for the private sector to issue debt of very long maturities, and thus allow business corporations to make longer-term commitments, augment its financial resources to finance plant and equipment, finance research and development, and other business expansions.

Now, let me turn to the outlook for the U.S. economy for the inflation rate which sets the backdrop against which Federal Reserve monetary policy must be formulated.

From my perspective, there's little likelihood that an imminent acceleration in the pace of business activity or a pick-up in inflationary pressures that would justify an immediate tightening of monetary policy.

All in all, we seem to be bottoming out perhaps cyclically in the inflation rate. In this context, the recent decision by the Federal Open Market committee to adopt the so-called asymmetrical directive can be interpreted as an attempt to quiet inflationary expectations by re-emphasizing the Central Bank's commitment to subdue inflation.

But from a practical policy perspective, I believe it's premature. The basic economic case for a move toward monetary restraint is not yet in place.

I'd like to draw your attention to the following factors.

First, while there are some elements of moderate strength in the new business situation, notably, demand for cars and light trucks and outlays for business and equipment, the manufacturing sector as a whole is not on a solid footing yet.

Second, business investment spending on new equipment has been a relatively strong component of gross product over the past several quarters, but its continuation is now questionable in view of the withdrawal of the proposed incremental investment tax credit.

Defense-related capital goods orders are conspicuously weak, reflecting the continuing down-sizing of the military, but even new orders for nondefense capital goods are beginning to languish.

Third, U.S. export prospects are diminishing, and that is because of the continuing slowdown in the European economies, the extraordinary economic and political uncertainties in Japan, and the increasing degree of international competition in Asian and Latin American markets.

And fourth, even outside the manufacturing sector, which accounts for only about a fifth of total employment, the American labor market remains quite soft, notwithstanding the slight pick-up in private-sector employment this year.

Fifth, there are still considerable drags on economic activity stemming from the overbuilding of commercial real estate and the financial consequences of excessive lending in this area. Real estate values continue to fall in important regional markets, most notably, in southern California, and new commercial building remains depressed in many areas of the country.

Sixth, homebuilding has moved ahead, particularly of single-family houses. But the increase in home construction is lagging well below cyclical dimensions.

Seventh, indeed, there is little evidence of a general rise in net credit demands from the private sector almost anywhere in the economy. For example, commercial bank lending and short-term borrowing by business through the issuance of commercial paper has demonstrated now real sustained growth in recent month.

Eighth, recent behavior of the monetary aggregates, while erratic, is not suggestive of an inflationary break- out. The growth of the targeted money supply remains well below the lower boundary of the Federal Reserve's targeted band.

And ninth, real commodity prices are weak. Far more important than the price of gold or some other precious metal, which the media likes to dwell on, is the price of oil. The price of benchmark West Texas Intermediate has fallen to around $18½ a barrel, as shown in my appendix. A year ago, it was $22½. And other commodity prices are also quite depressed.

The Journal of Commerce Commodity Price Index has slipped back sharply after a temporary rise earlier this year.

Now monetary policy, of course, is not made in isolation. Obviously, the evolution of U.S. fiscal policy has critical importance for the Central Bank.

Let me make three general comments about the fiscal outlook that I believe are particularly relevant for the conduct of monetary policy.

First, it's evident that fiscal policy is likely to produce little or no near-term stimulus to the economy and, on balance, may have a moderate restrictive cast.

Second, the emerging medium-term fiscal approach depends much more on tax and other revenue increases to achieve budgetary constraints than on spending reductions. In addition, the higher taxes are front-loaded in time, while the spending reductions incorporated in the program are back-loaded.

For the financial markets, the problem is naturally the danger of backsliding on intended spending cuts in outer years. And therefore, financial market participants will be eager to see whether the Congress is going to be resolute in assuring that those intended reductions are tamper-proof.

There is a strong case for explicit mechanisms within the scope of the budget authorization to make them tamper- proof, and the Federal Reserve would probably welcome this as much as the market would.

And third, I subscribe to the view that meaningful budgetary control over the long-term is not possible without a reasonable amount of tax increases. Critics sometimes lose sight of the fact that those people whose benefits are cut, that cut is the economic equivalent of a rise in taxes.

But I want to urge caution on the composition of tax increases because there is a dark side to nearly every tax. Many kinds of taxes are inherently inflationary and it would be wise to proceed with some care when contemplating imposing any of them.

Now I want to comment on the international economic and financial landscape and its implications for U.S. monetary policy.

For a variety of reasons, the global economy is not doing well and prospects for an early rebound are dim. Some of the impediments to satisfactory economic revival are specific to individual countries.

Thus, like the United States, the United Kingdom also has to contend with a shrinking defense sector and with the legacy of a vastly overbuilt commercial real estate situation. Its recovery from a long recession has been moderate.

Germany has to deal with the unprecedented challenge and heavy budgetary expenses of integrating a territory with entirely alien economic and financial culture into a modern competitive state. The upshot has been unacceptable high inflation, stringent monetary policy to bring it down, and a deep recession.

Italy has to restore business and consumer confidence in the wake of extraordinary political events.

And Japan has to surmount the formidable economic, financial, political and psychological consequences of the bursting of an overinflated speculative bubble, the emergence of a United States-style recession, and now the break-up of decades of old modalities of governance.

But putting aside these differences, there is a distinct common thread running through the restrained economic prospects of the major industrial countries.

In a nutshell, except for Japan, fiscal policy in the usual cyclical sense is inoperative, while monetary policy is encumbered everywhere. Fiscal policy is inoperative as a practical matter in Europe

because of large budgetary deficits that have been built up at all levels of government.

Only Japan has any scope for a significant fiscal expansion. But no one knows how political forces will shake out following the impending general election or whether the stubborn resistance to meaningful tax cuts on the part of the powerful segments of the previous government hierarchy and the ongoing bureaucracy will be shaken.

And thus, by default, therefore, I believe it is monetary policy that has been left with the full burden of reviving the industrial economies of Europe, as it has in the United States, and monetary accommodation still has a critical role to play in Japan as well.

But throughout the industrial world, monetary policy is encumbered. I believe there are four reasons for this.

First, a number of factors inhibit an adequate economic rebound that are of greater than cyclical dimensions. The downsizing of the military is one. Restructuring of business and financial institutions is another. Pressure to restructure is spreading from North America to Europe and to Japan, as an increasing number of corporations recognize that they're operating in a far more competitive market place than in the past and have no choice but to cut costs very forcefully.

This process leads more businesses to outsource, to manufacture, and even to provide services where labor costs are low. The capacity to do this has vastly improved with cheaper and more technologically advanced transport and communications networks, the lifting of political barriers, and the emergence of large new trading blocs.

These developments have also encouraged labor in economically distressed and in impoverished parts of the world to become more mobile. Millions of people have thronged into western Europe to improve the economic lot, and more hope to migrate. This will have a profound impact in keeping labor costs lower than they otherwise would be, limiting the bargaining power of organized labor and fostering certain reforms of social unease.

How is monetary policy to respond to these developments? There is no historical parallel to serve as a guide.

Second is the widespread financial impairment. In many of the key industrial countries, financial institutions which had participated in the excessive lending to commercial real estate or highly leveraged companies in the previous expansion, are still disabled. Even those which have been able to improve their profitability, their capital ratios and their overall financial health are not eager to lend.

Managements in these institutions are chastened. Lending officers are mindful of the criticism they received and have seen their lending authorities cut back. There is little evidence of financial institutions seeking actively to expand their lending. They are content to sit back and to wait for borrowers to appear.

Third, the much more deregulated financial markets we now have also tend to make it more difficult to gauge the effect of any stated degree of monetary accommodation. While the process of deregulation has proceeded unevenly and imperfectly, both within and across nations, the common feature is that there's far less seg-

mentation of credit markets. And as a result, wherever a steeply positively sloped yield curve has emerged the customary symptom of an accommodating monetary policy, banks and other financial institutions have stepped up their acquisition of marketable securities, particularly governments, in what started out to be a cyclical response. But this reaction seems to go farther and last longer than in previous interest rate cycles. Under these circumstances, we do not know what level of interest rates below today's levels will ignite dynamic credit expansion.

And fourth, Central Bank attitudes also may constrict the potential stimulative impact of monetary policy. Central bankers remember earlier periods when monetary accommodation was overdone and inflationary pressures were effectively validated.

They do not want to repeat that mistake. They are also mindful of the sensitivity of the bond markets to any hint of renewed inflation. Central banks are thus inclined to err on the side of caution in bringing about lower short-term interest rates.

Now the essence of the policy dilemma of dealing with this global economic and financial situation is that fiscal policy is generally not feasible, considering the budget deficits already in place, but that the central banks of the major industrial countries are hesitant to exercise stronger leadership.

The need is for a coordinated effort on the part of the major central banks to bring down world interest rates. But naturally, central bankers don't want to leave the impression that they have abandoned their fight against inflation. So they're inclined to hold back rather than to take the lead.

How much help would bolder monetary policy be at the present time in a global economy? In my judgment, a great deal. With the credit creation process still moribund, coordinated monetary accommodation would make a valuable contribution to invigorating growth and would be an acceptable risk to take. In fact, the bigger risk would be for central banks to temporize in deference to the conventional argument that more determined monetary easing would disturb the financial markets.

Under current conditions of extensive corporate restructuring, widespread softness in labor markets, and mild growth in money and credit, financial markets would readily accept additional monetary accommodation and would not construe it to be necessarily inflationary.

By contrast, far more disturbing to the markets would be a breakdown in the process of international economic cooperation and in the liberal trading system that lies at the heart of the process. Such a development, by threatening a progression of trade restrictions and retaliatory counter- restrictions, would carry with it the true danger of escalation of world inflation.

Now, the policy implications facing the Federal Reserve differs from that of most other major central banks in that unlike other countries, the United States has entered a business recovery, albeit, a moderate one, and has to weigh what is needed to sustain economic expansion against what is desirable for continuing downward pressure on the rate of inflation.

I believe that in the global context that I have described, the Federal Reserve should be able to pursue these joint objectives for

at least the time being by maintaining the present degree of monetary accommodation. It may also find the opportunity of taking advantage of the coming global deescalation in interest rates to edge the Federal funds rate somewhat lower, particularly if the U.S. dollar continues to display the kind of strength in the foreign exchange markets that it has in recent days.

By following this policy course, the central bank will retain the flexibility to react to a change in economic conditions, in particular, a more pronounced lift in the inflation rate.

What I do not favor is a pre-emptive move toward restraint on the pretext that this would somehow shore up the Federal Reserve's credibility in the financial markets and in so doing, relax the market concern about inflation prospects.

I have great doubts about conditioning policy on something as ill-defined as the notion of credibility. It is a policy argument that has an unfortunate tone of what I believe is self-righteousness, rather than a firm analytical grounding.

As a policy position, it's especially bizarre at the present time when, if anything, the financial markets have shown themselves to be quite comfortable with the overall stance of monetary policy.

The best evidence of this is displayed in the yield curve, which has become notably flatter this year. For example, the spread between the yield on 3-month Treasury bills and the yield on 30-year Treasury bonds has diminished from 440 basis points in January to about 355 basis points this week.

This is suggestive of a mild lessening in long-term inflationary expectations, even as the Federal Reserve has pursued a steady policy of monetary accommodation.

Now I also reject the proposition that a modest rise in the level of the Federal funds rate would have little significance for the economy, and so that such a preemptive move by the Federal Reserve would be costless.

To the contrary, a higher Federal funds rate would translate into higher interest rate payments by businesses and households, specifically those with adjustable-rate mortgages, a higher dollar in the foreign exchange markets, and some downward pressure on share prices. All would weaken growth prospects.

I also take issue with the assertion that a small increase in the Federal funds rate this summer would be welcomed by the financial markets and would accordingly lead to a decline in bond yields. Perhaps. But equally likely is that the bond market would interpret such a rise in the Federal funds rate as the first of a number of future increases and market participants might easily react by pushing bond yields higher.

But maybe such a preemptive move would reassure the financial markets that the Central Bank was determined to quell inflation and so would reduce inflationary expectations. But it is equally likely that the market would suspect that the Federal Reserve was in possession of information not yet publicly disclosed indicating the upcoming inflation news was going to be sour.

Under that scenario, the rise in the Federal funds rate could magnify the inflationary expectations, precipitating a sell-off of bonds.

A more systematic analysis of the present inflationary potential within the U.S. economy does not justify either exaggerated inflationary expectations or a preemptive tightening by the Federal Reserve.

Inflation, as depicted in the mostly commonly watched measure, the Consumer Price Index, is exaggerating actual price pressures. Inflation is not found in the business community and it is not revealed in speculative activity in the greater majority of product markets.

There is no evidence whatsoever of a surge in credit demands on the part of those wishing to finance speculative holding of inventories, commodities, or real estate, in contrast to the condition that prevailed during the previous run-up in the rate of inflation in the late 1970's.

There is no evidence of a tightening in labor markets that would presage an escalation of wage settlements. To the contrary, as I have detailed, labor markets are soft, and if we look at the stock market, we see a rather nondescript pattern with the market as a whole holding within a rather narrow trading range, but with the shares of individual companies susceptible to heavy punishment when earnings turn out to be less than what had been hoped for.

This is not symptomatic of a business setting characterized by generalized inflation.

The time will come—no one knows precisely when, perhaps in 1994, perhaps not until 1995 or 1996—when the business recovery will have matured, excess capacity will have been worked off, labor markets will have become more tauter, the economic recovery abroad will have begun, and commodity prices will have turned higher across the board and real estate prices perhaps may have firmed and credit demands will have become conspicuously stronger.

Then we will want the Federal Reserve to act with dispatch and determination to resist forcibly any build-up in inflationary pressures.

But none of those circumstances prevail today.

Thank you, Mr. Chairman.

Senator SARBANES. Thank you very much, sir, for a very strong statement.

Professor Samuelson, we'll be happy to hear from you, and then we'll go to questioning.

STATEMENT OF PAUL SAMUELSON, PROFESSOR, DEPARTMENT OF ECONOMICS, MIT, CAMBRIDGE, MA

Mr. SAMUELSON. Thank you, Mr. Chairman.

Senator SARBANES. I think if you could pull the microphone a little closer and speak right into it, it helps.

Mr. SAMUELSON. Thank you. I have mixed feelings in testifying here today. On the one hand, for a journeyman writer on baseball like me, like Grantland Rice, to appear with Babe Ruth is a Walter Mitty dream of glory.

[Laughter.]

That's the good side of the coin.

The CHAIRMAN. Notice the self-effacing modest blush on your colleague here.

Mr. KAUFMAN. That's quite a compliment coming from an individual who has such high ranking both nationally and internationally.

Mr. SAMUELSON. The other side of the coin is that it is summertime in Belmont, MA, the tennis courts are beckoning, and I need never have left home, because in the open-book test assignment that you give the two of us, without any collusion—I did not even know who was to appear with me—a prosecuting attorney could be forgiven for thinking there had been cheating and hanky-panky going on because our testimonies are so very similar.

And where they are different, it is only because I did not succeed in my intention and did not have the wisdom and detailed knowledge which is embodied in Mr. Kaufman's testimony.

But since the airfare has been paid and I am here, let me give my assenting opinion to the general tenor of Henry Kaufman's testimony and the specific points that he has made.

After a dozen years of structural budget deficits and low private-sector saving by United States families and corporations, economic history and economic science concur in the diagnosis that monetary policy, rather than fiscal policy, should be the major macroeconomic weapon for assuring a healthy 1993–1996 recovery, and for the restoring of the share of American-owned capital formation in the American economy.

Conan Doyle, in "The House of the Baskervilles," had Sherlock Holmes say, "Dr. Watson, did you note the dog that didn't bark?"

I note that Federal Reserve policy, which should be the keynote of almost every discussion, is hardly mentioned in policy debate and very little of an objective and critical character is said about that topic.

The last 5 years will go down in the textbooks of economic history as a period of disappointing performances by central banks. America's central bank, the Federal Reserve, began the decade of the 1980's with a stellar report card. Under Chairman Paul Volcker, from 1979 to 1982, remarkable progress was made in wringing out of our economy the double-digit stagflation that had built up in the 1970's.

Then, in 1982 and 1983, as I shall describe for its peculiar relevance today, the Fed did fire up the American locomotive in a prudent way, leading the United States and the global economies into a needed expansion.

Again, in the epoch when Alan Greenspan took over the helm from Paul Volcker, the nasty stock market crash of October 19, 1987, was brilliantly addressed by well-timed and judicious central bank support. What began as a potential world-wide disaster, fully as perilous quantitatively as the October, 1929 Wall Street crash, by good policy and, let us remember good luck, was contained from being the prelude to serious recession.

Well, that is the good news. Alas, future historians are forced to report that after 1988, Cinderella's hour had come and central banks have earned for their performances low marks.

In particular, the revered Bundesbank has brought on unified Germany a serious recession that it, the Bundesbank, never expected to occur. At an annual rate, the drops in output and production in Germany and even in Western Germany, are stupendous.

Outside of Germany, directly and indirectly, the bias of the Bundesbank toward preoccupation with inflation to the neglect of real growth and unemployment, has led to a lasting slump for Common Market and other European countries.

In the end, the dream of a Maastricht Treaty that would unify the European economy was dashed by Bundesbank intransigence. And, I may add, by a well-timed leak from the head of the Bundesbank.

Unemployment rates in Spain, Italy, and Ireland soared. Waiting upon the German credit expansion that never came, Britain, Italy, and Spain were forced out of the European Monetary Union. Countries like France that accommodated to the Bundesbank have been penalized by double-digit unemployment rates.

One of the advantages of living to an old age is seeing things you never dreamed to see. Also, learning how your friends' children turned out.

[Laughter.]

I never thought to live to see a Sweden with its interest rate forced temporarily up to a 500 percent annual rate in order to have the Kroner look the Mark in the eye. That's a spectacle that no economist ever expected to see again in the modern world.

The chimera of omniscient and independent central banks sadly contributed to the Bank of Japan's bringing on that dynamic society a serious stagnation of output.

Japan is blessed with good technology but terrible government. There is no responsibility bearing upon the bureaucracy from Tokyo University in the Ministry of Finance and in the Bank of Japan. Where an Italy or a Spain face, genuine international constraints, Japan's wounds have been self-inflicted and gratuitous. And in wounding herself, Japan has also wounded the United States's bilateral unbalance with Japan, thereby contributing significantly to our puny 7/10ths of 1 percent annual rate of American real GDP growth in the 1993 first quarter.

I'm referring to the worsening of our balance of payments, which is natural with a Japan so weak.

Were it not for involuntary piling up of inventory accumulation, our final real GDP would actually have been reported as declining in 1993's first quarter.

Alas, our Federal Reserve has shared in this central bank saga of acting too little and too late against macro weakness on Main Street USA. It can be said, soberly and statistically significantly, that the defeat of George Bush in 1992 and the Republican disappointments in the Senate and the House are the direct result of Federal Reserve misdiagnosis of the seriousness of the 1990–1992 state of U.S. demand.

Well, that is not my problem.

[Laughter.]

Yes, the Fed acted many times to help bring down short- term interest rates. Yes, those actions were important in the sense that without them, our banks, corporations, and job-seekers would have been much worse off.

I would like to scotch at the beginning the notion that the Federal Reserve has now shot its bolt and has reached the end of possible potency of central banking action. I have written, none more

eloquently than I, about pushing on a string in monetary policy. I have written about taking the camel to the water but not being able to make the camel drink.

I remember when I first went to Harvard as a knickerbockered boy, that no bank would accept my deposit. Even if I had had a letter of recommendation from a spiritual adviser, I would not have been able to be accepted then, when short-term interest rates were three-eighths of three-eighths of three- eighths of 1 percent. Ninety-day Treasury bills were not even cashed in at the end of 90 days. And when I asked a Treasury official how that could be, he said, Do you know a better way of holding $1 million?

Well, under those circumstances, and monetarists should take note of those times; the potency of monetary policy is indeed limited. 1935–1938 is not 1993.

Fed actions were important in 1990–1991. But no, successive open market committees did not act in time and in degree called for by the current statistical indicators.

Well, why not? I don't think I'll spend much time in speculating on that. I don't want to go into the credentials of the 19 persons who are entitled in any epoch to vote on the Open Market committee. But I do want to point out to you that in our division of powers in our Government, the present Federal Reserve structure creates a problem which is not unprecedented in history. All of those 19 appointments have been made in the period, the 12-year, 13-year period, of Reagan and Bush. The natural, every other year opening up of a vacancy could result in an intolerable mismatch between the will of the electorate as expressed both in the Houses of Congress and the White House and as revealed to be in the Federal Reserve. Were it not for the fact that those are really underpaid jobs for people with their kind of haberdashery and marketable skills and therefore—so that Fed brass doesn't stay in those jobs for the 14-year terms that are involved—the mismatch would be even worse.

As we say in science—science advances funeral by funeral.

[Laughter.]

Civil service and bureaucracy improves somewhat by voluntary retirement.

But, and this is a serious point, a significant minority of those 19 have been candid in telling us that their regard was, and that it ought to have been, solely to try to bring inflation down essentially to zero or 1 percent per annum by 1995.

Some, and I see two Senators here who were at the Joint Economic Committee testimony where I testified along with a former president of the Cleveland Federal Reserve. He quoted with approval and envy the charter of the Bundesbank, which makes stabilization of the price level the be-all and the end-all of that central bank.

And when he was asked by a feisty Senator, do you think that private individuals should be allowed to make binding macro judgments, they not having been subject to any approval by the Senate or the Presidency, he said, Yes, provided that there is the Bundesbank charter that they must only be concerned with the price level.

I have a friend in economics who believes in everything. Anything you can name, I have a friend who believes in it. One of my friends even believes that a machine should be running the Federal Reserve, one that would not make the mistake of ever looking to the right and the left to see whether unemployment has become 25 percent as it did in the USA in 1932.

Any jury of leading economists will, by majority vote, and that's the most you can hope for among economists, agree that only by contriving a weak U.S. economy like that of historical 1990–1993, could one have a rational hope of approaching that 1995 inflationless state.

Well, Main Street USA has not in town meetings given the Federal Reserve such a monastic mandate. Nor has a committee of the two Houses, or a majority vote in either of the Houses.

I believe this to be important, not as a matter of history or of general philosophy. It is important because the money market has every reason to believe, even without leaks to the press after Open Market committee meetings, that this Federal Reserve, the only one we have, is only too prone, (1) to engineer higher short-term interest rates or, (2) to countenance such higher rates—you see I'm reverting to my academic mannerisms—and to do this (A) at the first signs of a healthy real recovery, say a 3¼ percent annual growth rate for two successive quarters, or (B) at the first signs of some perceptible acceleration of price-level indexes.

Well, one of the advantages of being old is you have a long memory.

In 1958, within 3 months of the trough of the second Eisenhower recession, the Fed tightened interest rates to "stay ahead of the wave of the next inflation." The rest is history. The 1958–1960 recovery was short and weak—"nasty, short, and brutish" is how Thomas Hobbes would have described it—and the time was brief until the third Eisenhower Recession ensued.

John F. Kennedy was thereby able to defeat Richard Nixon and bring the Democrats back into the White House for 8 years.

By contrast, consider mid-1982, when the 1981–1982 recession did not end as expected. I testified in the spring of 1982. I was asked by an overconfident Senator: Professor Samuelson, when will this recession end? And since the man asked me, I told him.

I said, between Easter and the 4th of July, on May 15th comes the birthday of Paul A. Samuelson. The recession will end on that day at 11:30 a.m.

[Laughter.]

Well, I'm not always perfect. It didn't end then. I think Paul Volcker expected it to. But it didn't. And at that time, Chairman Volcker discerned a window of opportunity. He weighed, as the Central Bank should, the risks and rewards of zigging and of zagging and he moved—that is, he and his 18 colleagues—in the direction of expansion.

Many people warned that Wall Street wouldn't like that, that Wall Street would regard it as throwing in the sponge, as being soft on inflation. But in the event Wall Street acted as if it was wildly enthusiastic about this expansionary activism.

Immediately, the bond market felt it. Almost immediately, the stock market felt it. And the Federal Reserve gets the credit in the

history books for not only leading the United States out of what appeared to be a longer-lasting and more serious recession than had been feared, but only the American locomotive was operating at a time when the Japanese and the German locomotives were quiescent. And we led Main Street up the mountain, but also, led the world economy.

Paul Volcker did this in some degree by risking some overdoing. However, he permitted that to assure the recovery. And when the recovery was assured, the Fed changed its tack and overtightened a bit.

I recall how doctrinaire monetarists condemned the Fed twice. First, the Central Bank ran over a person and then the truck was backed up and run over the cadaver. That's the way they keep the score.

I keep the score the way a sailor keeps the score. You tack in this direction in the wind and then you tack in that direction. That way, you make your way into the wind. Those are not two errors. That is good optimal control theory.

Well, I elaborate on this because, for the reasons which Henry Kaufman has elaborated, the present healthy expansion has not been established. Indeed, it's almost unbelievable that the index of current indicators, which comes out at the same time that the disappointing index of leading indicators has been coming out—this index of current indicators could be expected to be up 7 or 9 percent from the trough dated by the National Bureau. Actually the Index of Current Indicators is barely up a percent from the low point of the turning point itself.

Well, I am not a pessimist who believes that we are in a vicious Kondratief downwave. I believe jobs can grow under prudent macro policies. I realize we have long-term structural problems brought on by a decade of disregard of many of the problems of American manufacturing and American corporate structure, and by frenzied real estate and banking finance.

I do believe that cutbacks in President Clinton's fiscal stimulus package, if they occur, should be the opportunity seized by the Federal Reserve for a pro-investment rather than a pro-consumption tilt to the United States GDP in this decade.

Binging on consumption was the aberration of the 1980's. The U.S. people, we private sector people, went on a consumption binge; and the structural post-Reaganomics deficits, which are not high unemployment deficits—they are deficits at low 5 percent unemployment—these are the devil's recipe for an economy with low capital formation and even lower American-owned capital formation.

So coordinating Federal Reserve monetary policy with austere fiscal-deficit reduction can be the single most important path for the 1990's, a needed corrective for the irresponsible 1980's.

Let me close with an important caveat, from which you can see Henry Kaufman and I must have colluded in preparing our testimonies.

Leaning against the wind of inflationary overheating is a vital duty of the Federal Reserve as a central bank. But it goes along with the Fed's equally vital duty to lean against the winds of self-aggravating recession.

The hardest task ahead for an intelligent and responsible Federal Reserve will be to distinguish between micro-caused inflation, due to one-time supply shocks and tax changes, and macro-caused inflation, brought on by diminished slack in person-power and productive capacity.

I hope you will remember where you first heard this distinction between micro-caused inflation and macro.

Macro inflation is self-aggravating. It feeds on itself. It gets worse and worse. And when you try to force the unemployment rate down below what the system can stand, you do not succeed in further reducing unemployment. What you do succeed in is generating a South American type of self-aggravating, possibly self-accelerating hyperinflation.

Micro-inflation is, by contrast, self-limiting in a significant degree. And I haven't the slightest doubt that if history works the way history has worked in the past, and if a Democratic president with two Houses that are Democratic, has success in fostering what Democrats are peculiarly called by Providence to foster—there will be still to come micro additions to the price level problem (higher energy taxes, health-care charges).

But it's extremely important to distinguish between those and between that which the Federal Reserve cannot tolerate in any degree, the overheating of the economy brought on by macro mismanagement.

On July 1, 1993, the weight of the evidence is against our economy as being one now constrained by resource scarcity and on the verge of macro heating.

Later, when and if the weight of the evidence shifts, that will be the good time to press gently on the brakes. That time is not now and actually, if you invite me to, I'll then leave the tennis courts and give my Cassandra warnings in that direction at that time.

Thank you.

Senator SARBANES. Well, thank you very much. I want to thank both of you. Before we begin the questions, I'm going to yield to Senators Sasser and Bennett, who have come in since the hearing began for any opening statement they may have.

I do want to say this before doing that. I think these are two of the most thoughtful and perceptive statements that I have ever sat through at a congressional hearing. We're very grateful to both of you for the obvious care and thought that went into preparing these statements and for coming here today to present them.

My own view is that they're so important, that I personally am going to undertake to see that they reach a number of policymakers in the administration and elsewhere in the Congress.

I think that these statements need to be very carefully reviewed and thought about by those that are involved in making economic policy and we're extremely grateful to both of you for the contributions that you've made here this morning.

Senator Sasser.

OPENING STATEMENT OF SENATOR JIM SASSER

Senator SASSER. Thank you very much, Mr. Chairman. In deference to time, I will ask that my statement be included in the record as if read.

Let me follow up on what you've just said, Mr. Chairman. I got here late after Dr. Kaufman had already started his statement and I intend to read it with great interest. I thank Dr. Samuelson for his statement.

Just let me say that I have been concerned for a number of weeks about the impact of the President's deficit reduction program on our economic growth possibilities.

In the next year, we'll be taking $40 billion out of the economy as a result of the deficit reduction program that we will be passing. I think it's doubly important, as our two very learned witnesses have stated today, that the Fed pick up the slack and we move forward without any alarmist concerns about inflation. We should move forward with a very relaxed monetary policy that will pick up the slack and move this economy forward.

I'm concerned about falling back into a recession or diminished economic growth as a result of the restrictive fiscal policy that we will be pursuing over the next year or two, and this makes it, I think, doubly important that the Fed move forward.

I might say, I couldn't agree more with Dr. Samuelson, when he says that the policy of the Federal Reserve in the period from 1990 through 1993 had adverse political repercussions for the former occupant of the White House.

I remember very well in the budget negotiations of 1990, in which I was a participant, the tacit agreement was that the Congress and the Executive Branch would enter into a deficit-cutting mode and we would surrender our tools for fiscal stimulus through the deficit reduction agreement, we would fall back on the Fed and they would take the responsibility for a more relaxed monetary policy, which would keep the economy moving along.

They didn't do that. Or they did it too little, too late. And partially as a result, in my view, we had the longest recession that we've had since the Second World War.

Thank you, Mr. Chairman. I look forward to some questions later on.

Senator SARBANES. Thank you, Chairman Sasser.

Senator Bennett.

OPENING STATEMENT OF SENATOR ROBERT F. BENNETT

Senator BENNETT. Thank you, Mr. Chairman. I'm sure Dr. Samuelson, when he was referring to the Republican disappointments in the Senate, did not have me in mind, when he was talking about 1992, or Mr. Bond, both of whom survived.

Senator SARBANES. There are always exceptions to the rule.

Senator BENNETT. OK.

[Laughter.]

I have a number of things that I would like to pursue with respect to these issues. I don't know whether it's more appropriate to do it in an opening statement or wait for the question period.

But I would like to make this comment in the nature of an opening statement, and then perhaps pursue it in detail in the question period.

As we hear the economists discuss the circumstances in which we find ourselves, and I agree with Dr. Samuelson that we can find

an economist of impeccable credentials to support virtually every proposition that anyone wishes to make.

One circumstance that I do not hear economists address is the fact that our current economic circumstance coincides with the end of the Nation's longest and, arguably, most expensive war.

For over 40 years, we have been locked in an international struggle that has taken a tremendous toll on our economy. I've just finished that portion of David McCullough's biography of Harry Truman in which Truman is reported to have come to the Congress and asked for a major increase in expenditures to fight the Cold War. And the book describes the horror with which that request was met by the Congress and President Truman's seriousness in standing by his guns and the economists of the time saying, we simply cannot afford those kinds of expenditures.

Of course, that was back in the 1940's that President Truman made that action. And it is only now in the 1990's that we are reversing that trend. There are those who argue that the excesses of the 1980's came from the Reagan-Weinberger reckless build-up, in the language that was used at the time, of our military capacity, all in the name of fighting the Cold War.

The Cold War is now over. Future historians can describe and discuss how it was won and why it was won and whether or not the Reagan-Weinberger build-up had any beneficial effect on it.

None of that applies here because we're faced with the reality that the Cold War is over and that the economy therefore is undergoing a post-war adjustment of major consequences. And in the face of that fact, it may well be that references to historical activities within the Cold War period—that is, the Eisenhower slump of the 1950's or the first Reagan administration problem in the early 1980's, and so on—have to be tempered with the recognition of a major structural change that's going on.

In my brief time in the Senate, I haven't heard anybody talk about the major structural changes in the economy as a result of the end of the Cold War.

The largest State in our country, California, is undergoing a recession bordering on depression. And it is no accident that California was the focus of most of the defense establishment. Partly because of the weather that allows you to test aircraft, it became the source of the aircraft industry back in the Charles Lindburg days, and now the tremendous unemployment that's occurring at McDonnell-Douglas and Lockheed and the other places that have been dependent upon Cold War spending.

I would hope when we get to the question period, that we can address that because my understanding, Mr. Chairman, is that this is not a typical inventory recession. That is, we didn't have a whole bunch of Chrysler New Yorkers on the back lot and we had to lay the workers off until the New Yorkers could all be sold, at which point the recession is over and everybody is called back.

We are laying off rocket scientists who will never be called back. We are shutting down huge industries that will never come into being again.

This administration, with a zeal bordering on glee, is determined to do that to the defense industry. I'm not arguing that issue today, but I think, as we talk about the economy, we have to keep in mind

that it may be that changing Fed policy is not going to solve all of the problems that are created by the end of the Cold War.

So I would hope to get into that in some greater detail in the questioning period, Mr. Chairman, and I'm grateful to have these two witnesses here. I was struck with one thing listening to Professor Samuelson.

It's much nicer to be listening to an economics professor when you're a senator whom he is trying to convince, than when you're a student who stands in fear and trembling of what kind of grade he may give you on your response. I appreciate the opportunity and look forward to learning as much as I can.

Senator SARBANES. Well, thank you very much.

Let me just enter a mild dissent to one thing you said. I don't perceive the administration cutting the defense budget with a zeal bordering on glee. I think essentially they're trying to make some hard judgments about priorities. I, for one, find no basis on which to warrant defense spending if it's not needed for security purposes simply as a job-creation device.

If you're going to do some spending for a job-creation device, there's other spending rather than defense which would make more of a contribution to the economy. So if it's not warranted on security grounds, I don't think you ought to be putting money into that part of the budget.

Senator BENNETT. And neither do I. I think the difference will come on what is security grounds. But that's a separate issue.

Senator SARBANES. Gentlemen, let me ask you this question. If you were thinking now about drafting the memorandum that you wanted to come out of the G–7 meeting in Tokyo on the economic questions, what is it you would want that memorandum to say? What commitment or course of future action on the part of the G–7 would you be pushing to have come out of the summit?

Mr. KAUFMAN. Well, I would strongly hope that the G–7 meeting would produce a very strong statement that, No. 1, interest rates in the industrial countries should be lowered further. That there should be a strong commitment by each of the leaders to speak to their central banks and particularly Europe, where interest rates are exceedingly high, that those rates be lowered.

That would perhaps provide some leeway for the United States even to make a modest move toward further accommodation, particularly if the U.S. dollar will remain stable, or perhaps even strengthened. That's No. 1.

No. 2, there should be a strong commitment by all of them to maintain free trade. The risk in the current situation, which is one of slow growth, where everyone wants to export, no one has the vitality to import, the risk is that we move toward greater trade frictions, toward regionalism, toward fair trade, toward managed trade, which eventually runs the risk of much, much higher rates of inflation. And therefore, let's get on with GATT. Let's get on with the Uraguay Round. Let's get on with NAFTA. But there has to be an increasing urgency here to resolve the trade problems.

No. 3, from my perspective in the financial markets, if we want to continue to have conducive markets, well-run markets, we need to have much more of an official coordination in terms of market

behavior, financial institutions involved, than we have at the present time.

There is an informal arrangement today in guiding markets and financial institutions internationally. Nevertheless, each major central bank, each major country has differences in approach. The only uniformity that we have now is some uniformity in capital requirements of banks. We don't have uniformity in trading practices, in reporting practices, in accounting standards, in markets and financial institutions in major international centers.

We have deregulated markets. That's fine. But we need improved oversights, improved knowledge, which we don't have. And the structure of the financial system globally is changing rapidly and we're moving in an official sense behind those events.

Senator SARBANES. Thank you very much.

Professor Samuelson.

Mr. SAMUELSON. I think the easiest case to pontificate about is Japan. Japan has for a very long time deliberately depended on export-led growth.

The Japanese officials who come to this country and to world conferences assure their colleagues that they intend to move away from that. They even had a famous report that was to build up the infrastructure and make Japan not just a good place for trucks, but a good place for human beings. But those things do not get implemented. The Japanese talked for a very long time about a $110 billion fiscal stimulus package.

Unfortunately, it was not the Ministry of Finance people who decide these things who were saying these nice things. And when you examined the package, it was like a souffle. If the postal savings of the Japanese government were directed toward covering up the weakness in the stock market, used in Mussolini-like purchases of shares—that was counted as a fiscal expenditure, just as if it was one of the expenditures at McDonnell-Douglas that supports employment and production.

Now, at the moment, the Japanese parliament has had a vote of no-confidence. The Liberal Democratic Party, the leading party for 30 years, is in a bit of disarray.

I don't know whom in Japan you talk to at the G–7. It reminds me of a time when at City College, a worried philosophy student went to the great Professor Morris Cohen and said, "I'm shaken. I'm not sure I exist. Could you prove to me that I exist?"

Professor Cohen said quietly, "It's not impossible that I could do that. But, pray, to whom would I address my proof?"

That's the one problem at Tokyo.

Germany is still another case. I am told by colleagues who are more knowledgeable than I, you only make the Bundesbank angry if you pick on them.

So I'm with you in asking at the G–7 for the Bundesbank to ease. You're right. But maybe the last thing in the world you should do is to send somebody to Dr. Schlesinger and lean on him.

The facts of real politics are that the United States is not now in the position that it was in Mr. Truman's time. We are not almost 50 percent of world GNP as we were then. We are 22 percent of the world GNP while being 5 percent of the world population. We are rich, but we are illiquid.

George Bush was a pauper at every international meeting. He had no spare cash.

It is very clear that the American locomotive has made a good try since the U.S. upturn almost exactly 2 years back. But it doesn't have the autonomous strength to do that indefinitely in the face of how it worsens our balance of payments. That's why we keep wanting the German locomotive, which is, of course, just a metaphor for the countries who have some elbow room in the EC and Japan to be joining in.

I'm reminded of the endless slump of the 1930's, which just fed on itself. First, you had the prophecies—by next year, we'll be out of the trenches. That didn't happen, and it became just a slow, slow, beggar my neighbor, self-aggravating thing.

Well, it really isn't necessary in this age. We don't have Credit Anstalt banks that are allowed to fail. Last year the Bank of New England was in terrible trouble, as I can testify to. I never thought to have an anxious moment again of that sort. But the income stream of the U.S. economy wasn't affected in the slightest degree by its collapse and takeover by the Fleet Bank.

I complain about the moral hazard which is involved in the present banking system and its deposit insurance system, where a mediocre official can play gambling games with the Government's money—heads, I win, and tails, the Government loses. Still, I remind myself of what it was like when virtually all the banks in Indiana, in my part of the world, failed. And those were not token failures. You actually lost your wherewithall forever when that happened. Not so under FDIC and FDSLIC today. Bank failure lose nought for the depositors and the Nation's macro dollar stream.

So what is needed for the G–7, if only you had sovereignty and could call them in to testify and terrify the way you are terrifying me at this time because of my fear of what grade you will give, you would have to say that this continued world-wide stagnation is an unnecessary stagnation.

Now there have been times when I've had to testify in the 1970's on the stagflation problem where there really were perplexing, maybe insoluable, trade-offs. Whatever you did to help the flation part of stagflation made the stag part worse, and vice versa.

The world, generally speaking, is not in this stage yet, for the reasons that have been spelled out here. And so, there should be a replay at the G–7 level of the drama and dialog which is involved here today.

Senator SARBANES. Thank you very much.

Senator Bond.

Senator BOND. Thank you very much, Mr. Chairman.

Gentlemen, I would say that the combination of wisdom enlightened by humor that you've presented us today gives lie to the Malthusian characterization of economics as the dreary science. It has been far more enjoyable than I at least remembered my economics courses many, many years ago.

The only one thing I could quarrel with is giving credit to the Federal Reserve for the defeat of the Bush-Quayle team. I believe that, like so many others, they earned it the old-fashioned way and

they deserved it by going along with ill-advised tax hikes and failing to set out an economic policy comprehensively and cogently.

I would ask, first, Dr. Samuelson, on page 6, you say cutbacks in President Clinton's fiscal stimulus package should be the opportunity sized by the Fed for a pro-investment rather than a pro-consumption tilt.

I'd like to ask one of the famous multipart questions. I've already cited what I think are concerns in the economy about the package. What kinds of cutbacks do you think would be economically helpful in that package.

Second, how do you see us tilting toward more of a pro-consumption policy? Does that envision something like a consumption-based income tax that has been discussed by several Senators on a bipartisan basis?

Mr. SAMUELSON. Well, it's interesting that you should ask that question because, just yesterday, I was interviewed by telephone by a business journalist. He said, Professor Samuelson, I want your comment on this problem.

He said, in some circles, there is considerable agreement that cutting down the fiscal deficit by expenditure reduction is economically better than cutting down the fiscal deficit by tax increase.

He said, I don't want the politics of that, but what is the mechanics of that? He said, in particular, I remember something in your textbook called the "Balanced Budget Multiplier," which seemed to suggest the opposite. And my answer is a typical economist answer that Mr. Truman would not have liked precisely because he didn't want a two-armed economist.

I say to his shade, Sire, you do want a two-armed economist because in our profession, one-armed economists come either with only a right arm or only a left arm, and then you have to bring in a two-armed fellow like me to adjudicate between them.

And so my answer to Senators and journalist is this: to a first approximation, Gertrude Stein had it right—a dollar is a dollar of deficit reduction. Tax-rise or spending-cuts are about the same.

He said, but I want the second approximation. I said, they bite right into the circular flow of the income stream of production, employment and so forth. Whereas, the tax increase bites in later when people cut down on their spending. We want deficit reduction to reduce private consumption. We want it to release resources for capital formation. And we want the Federal Reserve to ensure that the environment is right so that those resources do get transferred into capital formation and don't get transferred into macro economic self-aggravating stagnation.

To that second approximation, it's 180 degrees wrong to think that the expenditure cuts are more healthy for the current vigor of the economy than the tax increases.

He said, fine. I've got my quote.

I said, the trouble is you're quoting my second approximation and not the important thing, which is, whichever way the political cookie crumbles, if you want to get resources back into capital formation, which true supply side economics tells us the earning power and standard of living of the American people at the turn of the century depends upon, you have to change that consumption binge pattern which is in the family, corporation, and budget-deficit

sectors. The total saving of the Nation is the sum of those three components.

Senator BOND. Thank you, sir. Let me raise another question with Mr. Kaufman and for Professor Samuelson, if you want to comment on it.

You made strong statements about the inflationary impact of protectionism, and I would assume that that would include such ideas as mandating that our trade deficit come down by specific increments, say with Japan, an idea that has been bandied about here.

But I would ask that you focus on something that I understand is, unfortunately, the jurisdiction of this committee and which seems to have a life of its own, and that is wage and price controls.

I thought that we tried wage and price controls under President Nixon and President Carter, and I thought that we learned a lesson.

I must have missed my guess because I now hear discussions coming from certain task forces that are saying, we are going to make major reforms in the health sector, but we want standby price controls.

What is your assessment, Mr. Kaufman, of the impact of price controls in an area like that?

Mr. KAUFMAN. I have never been in favor of either wage controls or price controls because they do distort the allocation of resources. They make a distortion that cannot be long, that will eventually break out. And then, they do encourage an environment that looks like it is less inflationary, but actually, the underlying pressure is for greater inflation.

I would be opposed to that. I have never seen wage and price controls work effectively over an extended period of time. We had wage and price controls during World War II under great emergencies, under great stress, but not in an environment of peacetime, where you want an efficient allocation of resources.

The system is moving toward a freer environment rather than a more constraint environment. And particularly, I think that would be disturbing over a period of time in our international relationships.

We have a competitive world and we cannot escape that competition by putting in wage and price controls. Emergencies, yes. But we have no emergency in that sense. So I would be strongly opposed to that.

By the way, you mentioned a consumption tax. This is something that ought to be explored. And one of our problems in international trade is that we domestically have a shortage of savings. We need to have more savings to have greater investments. And if we had that, it would produce a much healthier international trade situation for the United States.

Senator BOND. Professor Samuelson.

Mr. SAMUELSON. I want to concur in substance and in detail with what Henry Kaufman has said.

Now, I'm not an expert on health economics. Where third-party payments are made and are not set in quasi- competitive markets, I would want to reserve judgment as to exactly what the useful role would be of temporary price freezes and so forth.

But, with that caveat, I agree completely. The August, 1971, Connally–Nixon introduction of price controls is almost a laboratory case where it helped the economy enormously for the 17-plus months before the election. And we paid for it in a subsequent period until, when they were removed, we paid back at least as much as we had gained earlier, and maybe a lot more.

Senator BOND. Thank you very much, Mr. Chairman. And thank you, gentlemen, for a most enlightening discussion.

Senator SARBANES. Thank you, Senator Bond.

Senator Sasser.

Senator SASSER. Thank you, Mr. Chairman.

I want to propound this question to both Mr. Kaufman and Dr. Samuelson. But, as I indicated earlier, the Congress is about to enact about a $500 billion package of fiscal restraint. At least that's what the Congressional Budget Office evaluates the package at.

Now, discretionary spending is going to be frozen for 5 years. We're going to free discretionary spending in this package at $548 billion. If it survives for 5 years, this will mean a 12½ percent reduction in real terms in discretionary spending over the 5-year period.

The Senator from Utah, Mr. Bennett, has already indicated that the contraction in defense spending, military spending, is having an adverse effect on the economy in localized areas, specifically, California, and probably a generalized adverse impact on the economy in the short term.

Now with regard to other Government spending in the mandatory area, these entitlement programs—Medicare, Social Security, to some extent—are going to be effectively cut.

In addition to this reduction, we're going to have an increase in taxes that are targeted principally at the upper income taxpayer.

Now, in essence, we're doing the same thing we did in 1990, and that is, we're tying our fiscal hand behind our back here in the Congress.

I want to ask this question. I think the answer is obvious and I think both of you have perhaps answered it in your statement, but I want to get it on the record for all to read.

What's going to happen to unemployment and to our efforts to control the deficit if the Fed does not accommodate this fiscal contraction with an accommodative monetary policy?

Would you like to go first, Mr. Kaufman, and then Dr. Samuelson?

Mr. KAUFMAN. I assume what you describe here is that these expenditure constraints mean a slowing in the growth of expenditures, not a complete decline in absolute terms.

Senator SASSER. Well, there will be a decline in absolute terms in discretionary spending.

Mr. KAUFMAN. But in the others, there will be a slowing in growth of expenditures.

As I indicated before, first of all, for the immediate future, where is very little, if any, fiscal stimulus coming out of these budgetary deliberations. And indeed, that kind of conclusion is reflected in the markets because long-term interest rates have declined and with the expectation that the governmental role in the American econ-

omy over the next year or so would be very modest. And equity prices have increased and are at relatively high levels.

There has been a receptive financial market developing during this period. Part of that was due to, my belief, at least, that the President opted for a very modest posture on the fiscal side in this next year or so, in contrast to some of the advice he got for a fiscal stimulus package of $60 billion or more, which the President did not accept. Apparently, the Congress did not accept it, and I think that was the right decision. But there were proposals from a variety of places for a significant fiscal stimulus package.

If that would have been in place, the level of interest rates today would be higher and the equity market probably would have been in danger. So under these conditions which you describe, there are also several other things to remember.

We are putting in place here presumably some tax increases.

Senator SASSER. Yes.

Mr. KAUFMAN. Some of those tax increases will go into the inflationary indices and will produce some increases at that time in the inflation rate.

So, in that sense, we could say, well, but that is a one-time affair, which probably is true. But, nevertheless, it has an impact on the inflationary indices and there may be some tax increases that you may put in place that will have marginal impacts of an upward sort on the inflation rate, not just one time, but several times, as we go along. In that, the central bank has to clearly evaluate what its significance is.

My belief is——

Senator SASSER. Are you talking principally about a consumption tax here, such as a tax?

Mr. KAUFMAN. For example, a gasoline tax has inflationary implications.

Senator SASSER. As opposed to an income tax.

Mr. KAUFMAN. Well, that's correct. But I'm talking about excise taxes and so on. The Federal Reserve has to weigh that in its significance in terms of inflationary expectation.

Now perhaps oil prices will go down during this period and the increase that you may have in an energy tax will be hidden underneath this. But, nevertheless, in a micro-sense, there is an inflationary significance.

My belief is that the Federal Reserve in this period will not move aggressively to restraint, that the economic conditions are not there, that GNP growth will be modest, that the inflationary indicators will not rise up significantly, that international competition will be very intense and hold down the price structure, that the labor situation will continue to be conducive to economic stability rather than excesses, as such.

So, all in all, I would expect for the time being, monetary policy to be cautious rather than to move significantly to any sort of restraint.

Senator SASSER. Before I get to Dr. Samuelson, Mr. Kaufman, what happens if your anticipation with regard to the Fed is not correct? What if the inflation hawks in the Open Market Committee decide that we need to take a pre-emptive strike against inflation? Then what happens?

Senator SARBANES. The last Open Market committee meetings that are available, which are from March 26—that's another problem, how late we get these things. I might ask you all later about that. But two of the governors dissented at that time in favor of tighter monetary policy. I won't quote it all to you. They set out a lot of the reasons for it, all of which have been thrown into the trash can by your testimony this morning in terms of what actually happened in those different sectors that they were pointing to as warranting this kind of conduct.

But, nevertheless, they may go ahead and do it anyhow. I think it's a very important question that Senator Sasser has placed.

Mr. KAUFMAN. I would hope that the Federal Reserve will delay that tightening decision, that the conditions are not ripe for any tightening at the present time, given what's happening in Europe, given the status of the situation today. Senator Bennett asked about the structural changes that are coming on us.

We have a whole series of them. The military is one, a very important structural development. We have restructuring in business corporations that continue to be announced. Restructuring in business means getting rid of part of the business, meaning decreasing the number of people employed. And this is not just in the military side, but it's in the civilian sector.

We have today a mobility of labor which I tried to mention before, which is way beyond anything that we've had before in modern times. Today, you can outsource as a business corporation. If you're in western Europe and Germany, you can go to Hungary. You can go to Poland. You can go to Czechoslovakia and outsource. And we're outsourcing here in the United States significantly in a variety of countries.

And we have migration into areas that are economically stronger from areas that are very weak, whether it is Eastern Europeans going into Western Europe or North Africans going into Western Europe, or Chinese wanting to come into the United States or South Americans wanting to come to the United States.

This mobility is having a restraining influence on labor. It is a structural development far beyond anything that we've ever seen in the post-war period. And we have this lingering problem of a credit crunch, which is a structural problem, as I tried to indicate. How do you assess when this financial system can be more vibrant? There is no econometric model which you can utilize. And I would think that these are the forces that hopefully the central bank will weigh and therefore delay monetary tightening.

But if the Federal Reserve were to move toward tightness here, toward reversing its posture very soon, I would think it would slow economic activity.

Senator SASSER. Dr. Samuelson, do you have any comments to make on that question?

Mr. SAMUELSON. Well, I think your concern is well placed.

We have had a structural deficit for a long time. That is now built into the system. The system depends upon that deficit.

In the face of large percentages, unprecedented percentages of the GNP, going into a structural deficit, we still have had weakness in the economy.

Now, if you superimpose a warranted reduction in Cold War expenditures and take no account of continuity in that process, if you consider the gridlock on Main Street about fundamental philosophy, which leads to a certain undermining of confidence, and if you, in this period of time, try to make up for some of the chronic deficit of the earlier period of time, and if you added to that a truly independent Federal Reserve, monastic in its policy goal, and considering it an overdue task to bring on price stability, to grind out that last 4 percent or 3 percent of price inflation that's in the system, if you ask me, is there a danger that under those circumstances, all is not going to be rosy on Main Street, I'd say the question answers itself.

There sure is possible danger. I don't think you can expect from the Federal Reserve, certainly not from this Federal Reserve, an agreement in advance that it will do all sorts of things to fill in for anything adverse which happens.

What we can ask for is that it weigh the weaknesses on the real output side, that it consider the importance of moving resources from their old uses not into idleness, cumulative idleness, but into capital formation and that it tilt in that direction, taking account that each little acceleration of inflation is not the sign that somebody really smart knows what's ahead.

Nobody mentioned gold here. You'd be surprised how the financial press keeps asking me, why did gold go up? George Soros must know something that we don't know.

Yes, he knows what his position is and he tells us after he's taken it in a way which—I won't say it's self-serving, but it is not self-hurting.

[Laughter.]

That is treated as seriously in the chicken-a-la-king speeches by the apparatus of the Federal Reserve as other price changes.

Now, let's consider one process which is part of the process of healing. The dollar has depreciated. This is the rational way of adjusting to our balance of payments deficit. It is not something which in the long run is harmful to the American pride or to the American economy.

There is no way within economic science that this cannot have, while it is happening, a once and for all effect upon the price level of imported goods. In fact, it has this effect after the depreciation happened because of the delayed J-shaped effect.

If each hawk on the Federal Reserve uses that as the reason for returning to a vendetta—you know how Cato, the elder, after every speech in the Roman senate, said, "Carthago delende est—Carthage must be destroyed."

Well, we have our Catos in the Federal Reserve. Inflation is obsession and paranoia. This is not the time to immediately put the price level in order as seen by such zealots. I think there is a problem because very few people want to turn the clock back to where, day by day decisions of the Federal Reserve are monitored by mean Senators and meaner House of Representative members. But there can't be a fourth power of Government—the Judiciary, the Executive, the—I can't remember what the other one is.

Senator SARBANES. Legislative.

Mr. SAMUELSON. And the Federal Reserve. So there is a dilemma over improved Federal Reserve governance.

You don't have to borrow trouble, though, by trying to decide now exactly what the magnitude of the problem is. What you have to do is formulate now a flexible way of looking at and responding to those problems.

There are some good elements in the picture. For example, the loss of consumers' confidence. That's a fragile loss. It can come back and it can be sustained and be a rational consumer confidence based upon the American economy finding its momentum again.

The easiest thing in economics is to think you're at the end of the world. It's always hard to see where the good news is going to come from in the next period. It's usually pretty easy to see where some of the bad news may come from.

We have the tools to grapple with the problem, not to fine-tune them, not to solve them in each short period of time to a perfect degree, but not to let them grow on us and fester and accumulate.

Senator SASSER. My time is expired.

Senator SARBANES. Thank you very much, Senator Sasser.

Senator Bennett.

Senator BENNETT. Thank you, Mr. Chairman.

Mr. Kaufman, I wish you had been here when Ross Perot sat at that table. I could have used a little help.

[Laughter.]

I was the only voice speaking out in favor of NAFTA and free trade and the idea that we do indeed rise or fall in the future in terms of our ability to compete in the world market place and the days of protectionism are over. So I'm delighted with your comment on that.

I'd like to go back to—and by the way, I also agree completely that the end of the Cold War is not the only major restructuring.

Whether it's by accident or some sort of connection, the restructuring that's gone on in General Motors and IBM and the huge corporations that have had to down-size, it's a great euphemism for laying people off, to meet global competition, seems to have come at the same time as the ending of the Cold War and creating all of the kinds of stresses.

I'm delighted to have you say that there's no econometric model to forecast all of that because that's one of the things that I've been saying also as people have asked me what is going to happen.

Let me go now to a comment that Professor Samuelson made and get a reaction, as you describe our Nation as being rich but illiquid. I've not heard that phrase before. I'm fascinated by it. And it triggers in my mind a discussion of the capital gains tax because, in my experience, very limited, but very practical, illiquidity among the venture capitalists whom I know seems to be exacerbated by the capital gains tax rate.

That is, they feel locked into an investment that they would now like to sell off to someone who is prepared to accept a slightly lesser return than they are looking for, but feel that they cannot turn their capital over to the more conservative because of what amounts to prohibitive capital gains tax rates.

And one of the things this Congress has just done is raise capital gains tax rates. Could you set me straight on that one?

Mr. SAMUELSON. Well, let me first say that sometimes my tongue is too clever by 'arf. I coin a phrase which is grammatical but is not precise.

When I speak of illiquid, I'm not thinking of the difference between a portfolio of open-end mutual funds in Government bonds and in real estate, where it's unrealistic to be able to mark to market at any one time all assets and to know what the crisp, both bid and asked, is, as a single number.

It's the absence of spare cash, of discretionary, disposable income at the behest of the Government which is the contrast I was drawing our attention to between the Marshall Plan days of President Truman and recent days of George Bush.

The Japanese or the Taiwanese built up huge reserves from balance of payments and other surpluses. They have liquidity we don't have, even though, if you make the calculation correctly, the Japanese standard of living, properly recognized, is not 100 percent of the American. It's only about 80 percent.

But now, let's turn to the capital gains tax.

Capital gains tax reform is overdue. Its principal defect under the present system is that there is no allowance made for the mere passage of time and price level creep, so that the house that you bought at $30,000, in the market decades later has a $210,000 value. And if you were to sell it and not be able to roll it over, that gain could be treated as a genuine increment of your income. Whereas, if you had to replace it——

Now, we could have reform of capital gains taxation that fixes this. But it is a can of worms. It is not a simple thing, where we just pass a law one afternoon on that.

What you have to do is to simultaneously pass a law so that Paul Samuelson cannot go and borrow at interest which is tax-deductible and put those funds into things which acrete with the price level. Because if you don't do that, you've created a thermodynamic machine which operates between two tax-rate temperatures and I can then grind an indefinite amount of tax avoidance at the Government's expense.

Now, I've heard a lot of talk in high places about reducing the capital gains rates. I've not seen any serious commitment to doing the things which will need to be done for genuine integrated reform.

George Bush, in 1992, had one proposal only: Reduce capital gains tax rates. Economic analysis reveals this is quantitatively a small factor in the micro and macro picture.

The stories that have been told about what was unleashed in the way of venture capital in the mid-1980's by the reduction in tax rates and so forth, when you check into them don't stand up.

It's we in the Ivy League colleges and Pension Funds and so forth that were constantly investing, sometimes to our sorrow, in these venture capital funds, and we are in the zero-tax bracket.

In superficial econometric studies, our venturesomeness gets in on a post-hoc ergo propter-hoc basis, as signs that you have unleashed tremendous new amounts of behavior.

I would say that lots of what are called capital gains are quasi-automatic and grow up with the country. A lot of them are not distinguishable from ordinary income. I can contrive to buy bonds at

a discount that accrete and produce exactly the same income as my other bonds do. One may be treated as a capital gain, the other may not be.

Today, the difference between 28 percent and 31 percent is miniscule. The difference between 28 percent and 39.6 percent is not minuscule and you will get the thermodynamic machines of the accountants and lawyers working. But, of course, Senator Bradley had a cure for that. It's the difference between the rates that creates the loophole, and so he has suggested that the affluent people who play this game, namely, people like me in certain economic brackets, that we not get a 28-percent ceiling. A lot of enthusiasm for capital gain reform disappeared in the face of that alternative.

Senator BENNETT. Let me give you a real-life example and let both of you comment on it.

I was involved in the creation of a new business. Stock was sold in the business at $1 a share, a typical example of a brand-new business. That's where you price it when you're getting started and raising money from friends and relatives.

We were successful and reached the point where the company increased in value and people were willing to pay $30 a share.

An individual, and I'll keep the numbers simple for calculation purposes, who put in $3,000, therefore had value of $100,000.

We had such an individual in the company. He was a venture capitalist and he came to us and said, the ride is over in this company. From now on, the company shares will increase at the rate of somewhere between 5 to 10 percent per year and I'm not interested at that rate. I would like to take my money out and I have an investment over here on which I think I will get a 30-percent return.

We said to him, that's fine. We can find a buyer for your stock. There's no problem at all. But let us point out something to you.

Your asset now is $100,000, right? Yes. OK, and it's growing at somewhere between $5,000 and $10,000 a year. Yes. And he said, I'm not satisfied with that return.

So in 4 years, you're going to have $130,000 to $140,000. Yes. All right. You sell your stock. You're going to realize not $100,000 to invest, but $65,000, after you pay your Federal and State—and one of the things I get excited about here in Washington is that nobody pays any attention to State—taxes. Nobody thinks that you pay any State taxes. They do all of their calculations on the economy on the assumption that the State tax burden is zero, and they say the Federal tax rate us set at 28 percent, or whatever.

This occurred when 28 percent was the Federal level and he lived in the State of California. So his incremental rate was going to be 11 percent. You can deduct the State tax from the Federal tax, but all right, you're going to end up with about $65,000.

Now how well do you have to do in the next 3 years to turn that $65,000 into $130,000? I'm going to have to double my money in 3 years just to get even. What's your best investment? Well, his best investment is to leave his capital right where it is.

Now the kind of people who would buy his stock and be satisfied with the 5 to 10 percent return were willing to do that, but they didn't have any place to go, if we reduce the universe just to this

one transaction. They didn't have any place to go because it wasn't to his advantage to sell the stock.

The new venture that presumably could have earned him 30 percent the first year and then tapering off years after, was starved for capital because he couldn't get his out. And that's with the capital gains rate at 28 percent.

If you were to say to him, to use President Bush's number, your capital gains rate is now 15 percent, so you add that to your State tax rate, so that instead of $65,000 left to invest, you're going to have, let us say, $80,000 or $75,000, you'd say, well, from a $75,000 base, I can catch the $130,000 that it's going to be worth in 3 years with the increased investment. Then I will start to make this capital available.

Now, I apologize for the length of that example, but I share it with you because those are the kinds of experiences that I have had. This is a real company. This is a real circumstance. This is a real investor. This is a real calculation that we went through. This is not some econometric model. These are real people reacting to real circumstances.

Would you comment on that now in terms of where the capital gains rate ought to be?

Mr. SAMUELSON. Senator, your problem, your real-world problem is precisely the problem that we assign every week at the Sloan School of Management as homework problems for our operation analysts.

Now, when we ask them, could you design a more neutral capital gains tax structure, the deeper ones finally come in and say, well, you know, if you didn't allow the loophole of putting off the accruing gains, there wouldn't be this locked-in problem. So let's mark to market.

However, we don't want to be unfair. Let's have complete loss offsets. The $3,000 limit on how much you can write off was written in the law in the Great Depression in a misguided moment by populist legislators who didn't like the idea, and I speak of specific names, that Andrew Mellon and John D. Rockefeller didn't have any tax liability during the years of the Great Depression because they had so many generous tax losses on the books. And so Congress said, we're going to put a limit on that.

Well, as soon as they put the limit, that was the evil because it meant, on your winnings, if you're taxed at ordinary rates, you pay the full tax. On your losings, you don't get a loss.

So clever economists said, Yes, the way that should have been corrected is to have full carry-forwards, carry-backs of losses against gains. And then, mark to market. Now that will create some real liquidity problems in certain assets. You will have that problem.

Or to take a different problem. I'm a good deal older than you are, Senator. So it is not prudent for me to sell certain investments that I bought a long time ago, even though my objective analysis of where they're going in the future is bleak.

Now there's a way of correcting that locked-in effect and the law did correct it. When my late wife died, her estate was not able to take advantage of the write-off at death. However, Congress, in its

infinite wisdom, within the 3-year period before her estate was settled, killed what it had put in in its infinite wisdom earlier.

So there are many ways of making the capital gains tax more neutral in its effects upon the real economy. But a 15-percent tax rate, I assure you, is going to do a lot for the lumber business. It's going to do a lot for the cattle business. It's going to do a lot for things which grow in time, not because of inflation, but just because of the biological facts of life.

We'll be back to the races—I mean we accountants and tax lawyers and operations analysts—devoting another 5 percent of the GNP to what's called tax avoidance.

Mr. KAUFMAN. Senator, I must say that I do believe the answer to your question really is that you do lower capital gains tax and you raise some consumption tax in order to offset the loss in revenue because the very thing that you describe has other negative aspects from a financial market viewpoint because the individual equity-holder which you have could easily have gone and taken those shares and used them as collateral and borrowed, just like we've had in the 1980's. Many times, instead of selling a piece of real estate property, the increase in value was monetized by borrowing more. And the borrowing more was really preferable because of the tax structure.

The borrowing more meant that there was a higher level of indebtedness, financing that should never have occurred, if you would have given the opportunity from a tax viewpoint to sell that piece of property into the open market or to sell those shares into the open market because it leads to much greater level of marginal borrowing than distorting the financial system and creating marginal debt over a period of time.

Senator BENNETT. You're exactly right because another investment that I have, even though I've had to withdraw from the company since I've been elected to the Senate, has caused me not to sell my shares and I'm simply calling my broker and saying, add so much to my margin account as I now invest in this, that or the other, pledging those shares as collateral. I have no intention of selling them because of the capital gains.

I apologize for taking so much time, Mr. Chairman.

Senator SARBANES. No. Well, gentlemen, we want to thank you. I think it's very important to underscore the pragmatic conclusions in both of your statements. In other words, your judgment that under current circumstances, and correct me if I don't read this correctly, that under current circumstances, do not warrant a tightening of monetary policy. And in fact, might well warrant some further easing. But that that doesn't preclude, shouldn't preclude a watchful eye that would lead to a shift in the direction of monetary policy if in fact pressures began to build up that would seem to call for it. So it seems to me it's a very balanced approach that both of you are putting forward here today.

I'm deeply concerned because the Fed has constantly come to us and said, well, you've got to get the budget deficits down and we're trying to do that now in terms of the fiscal policy. Now we run the risk that it may be of such dimensions that it may trigger the economy into a downturn.

Of course, if that happens, the budget deficit will go up, not down. By trying to do too much, we will end up doing too little. It seems to me the minimum we need in order to try to make this approach work is an accommodating monetary policy at the time that we are moving to constrain fiscal policy.

I don't see anything in the economic landscape that argues against doing that. I don't see an inflationary problem under current circumstance. Monetary policy gives you a certain flexibility and an ability to move fairly quickly. And it seems to me that we need to, if we're going to try to get this economy restored and moving, we have to find some place where we are going to get some impetus, and hopefully, we seem to be counting on monetary policy, even though—I appreciate you can't push on a string, so it may not happen, but we seem to be getting some response out of that area.

I'm very concerned about that—I read these minutes coming out of these Open Market committees and see that some members there want to tighten monetary policy. Then I look at the rationale that was given for it. This goes back to March 26 now. None of the rationale has been sustained by subsequent developments. So I think it's very important to have the benefit of this kind of testimony.

I do want to repeat again what I said at the outset to both of you, that I think that these were as well reasoned and as cogent a presentation on a very important subject as we've received in the Congress in a long time.

In fact, I'm hard put to remember a comparable panel at this level of perception and analysis and we're very grateful to you for coming this morning and for the time and effort that was taken in preparing your testimony.

Thank you very much.

The committee stands adjourned.

[Whereupon, at 12:25 p.m., the committee was adjourned.]

[Prepared statements and response to written questions follow:]

STATEMENT OF SENATOR JIM SASSER

Thank you Mr. Chairman for calling this hearing this morning The future direction of monetary policy is of the utmost importance.

The Nation stands at a critical juncture. Millions of Americans are anxious about their jobs and their future.

Many have lost faith in the process of Government. To them, the budget deficit has come to symbolize political gridlock. This gridlock has deprived the American people of any meaningful Government action on the economy.

President Clinton has courageously addressed this problem head on and the Congress has followed his lead.

We are on the cusp of enacting a $500 billion deficit reduction package.

The stakes are high. Millions of jobs and, again, the very credibility of our Government are at stake. In my judgment, all must be done to make this effort succeed.

The risk of failure is all too real. The global economy is mired in recession. Our economy is growing slowly, at just 0.7 percent rate in the first quarter of 1993.

The most recent indicators are not particularly encouraging, although this morning's 11,000 drop in initial unemployment insurance claims is indeed good news.

Still earlier this week the Government's main forecasting gauge, the index of leading economic indicators, fell 0.3 percent in May. And just yesterday, we found out that factory orders fell again in May.

Moreover, an "insurance policy" was lost when the President's Jobs Bill was blocked.

If this deficit reduction effort is going to succeed, the Federal Reserve must be a full partner. The Fed must do its part to ensure job creation and falling unemployment.

Indeed, we cannot afford a repeat of what followed the 1990 budget agreement. That agreement was overwhelmed by a weak economy that the Fed failed to keep afloat.

Mr. Chairman, I look forward to hearing from our two distinguished witnesses on how the Fed should conduct its monetary policy and be a partner in the success of our deficit reduction effort and a revitalized economy.

Thank you Mr. Chairman.

TESTIMONY OF PAUL A. SAMUELSON

Optimal Federal Reserve Policy for 1993–94

Thursday, July 1, 1993

After a dozen years of structural budget deficits and low private-sector saving by United States families and corporations, economic history and economic science concur in the diagnosis that monetary policy rather than fiscal policy should be the major macroeconomic weapon for assuring a healthy 1993–96 Recovery and for restoring of the share of capital formation in the American economy.

The last five years will go down in the textbooks of economic history as a period of disappointing performances by central banks. America's central bank, the Federal Reserve, began the decade of the 1980's with a stellar report card. Under Chairman Paul Volcker, from 1979 to 1982 remarkable progress was made in wringing out of our economy the double-digit stagflation that had built up in the 1970's. Then in 1982 and 1983, as I shall describe for its peculiar relevance today, the Fed fired up the American locomotive in a prudent way, leading the United States and the global economies into a needed expansion.

Again, in the epoch when Chairman Alan Greenspan took over the helm from Paul Volcker, the nasty stock market crash of October 19, 1987 was brilliantly addressed by well-timed and judicious central bank support. What began as a potential worldwide disaster, fully as perilous as the October 1929 Wall Street Crash, by good policy and good luck was contained from being the prelude to serious recession.

That is the good news. Alas, future historians are forced to report that after 1988 central banks have earned for their performances low marks.

In particular the revered *Bundesbank* has brought on unified Germany a serious recession that it never expected to occur. Outside of Germany, directly and indirectly, the bias of the *Bundesbank* toward preoccupation with inflation to the neglect of real growth and unemployment—this has led to a lasting slump for Common Market and other European countries. In the end, the dream of a Maastricht Treaty that would unify the European economy was dashed by *Bundesbank* intransigence. Unemployment rates in Spain, Italy, and Ireland soared. Waiting upon the German credit expansion that never came, Britain, Italy, and Spain were forced out of the European Monetary Union. Countries like France that accommodated to the

Bundesbank have been penalized by double-digit unemployment rates. A Sweden with its interest rate forced temporarily up to a 500 percent annual rate in order to have the Kroner look the Mark in the eye is a spectacle no sage ever expected to see again in the modern world.

The chimera of omniscient and independent central banks sadly contributed to the Bank of Japan's bringing on that dynamic society a serious stagnation of output. Where an Italy or a Spain face genuine international constraints, Japan's wounds have been self-inflicted and gratuitous. And in wounding herself, Japan has also wounded the U.S. bilateral unbalance with Japan, contributing significantly to the puny .7 of 1 percent annual rate of American real GDP growth in the 1993 First Quarter. Were it not for involuntary piling up of inventory accumulation, our Final Real GDP would actually have been declining in 1993's First Quarter.

Alas, the Federal Reserve has shared in this central bank saga of acting too little and too late against macro weakness on Main Street USA. It can be said, soberly and statistically significantly, that the defeat of George Bush in 1992 and the Republican disappointments in the Senate and the House are the direct result of Federal Reserve misdiagnosis of the seriousness of the 1990–92 state of U.S. demand.

Yes, the Fed acted many times to help bring down short-term interest rates. Yes, those actions were important in the sense that without them our banks, corporations, and job-seekers would have been much worse off.

But no, successive Open Market Committees did not act in time and in degree called for by the current statistical indicators.

Why not? I do not think the nineteen persons who are entitled in any epoch to vote on the Open Market Committee are at this time less competent than in the past. Nor are they more poorly informed than the 50-odd consensus forecasters at our corporations, banks, and universities who publish current analyses and recommendations. All of these nineteen have been appointed to office in the Reagan-Bush years. A significant minority of them have been candid in telling us that their regard was—and ought to be—solely to try to bring inflation down essentially to 0 or 1 percent per annum by 1995. (Some have quoted with approval and envy the charter of the *Bundesbank* which makes this the be-all and the end-all of that central bank.) Any jury of leading economists will by majority vote agree that only by contriving a weak U.S. economy like that of 1990–93 could one have a rational hope of approaching that 1995 inflation-less state.

Main Street USA has not in town meetings given the Federal Reserve such a monastic mandate. Nor has a committee of the two Houses, or a majority vote in either of the Houses.

I believe this to be important not as a matter of history or of general philosophy. It is important because the money market has every reason to believe—even without leaks to the press after Open Market Committee meetings—that this Federal Reserve, the only one we have, is only too prone to (1) *engineer* higher short-term interest rates, or (2) *countenance* such higher rates (a) at the first signs of a healthy real recovery—say, a 3¼ percent (annual) growth rate for two successive quarters, or (b) at the first signs of some acceleration of price-level indexes.

In 1958, within three months of the trough of the Second Eisenhower Recession, the Fed tightened interest rates to "stay ahead of the wave of the next inflation." The rest is history. The 1958–60 recovery was short and weak. John F. Kennedy was thereby able to defeat Richard Nixon and bring the Democrats back into the White House for eight years.

By contrast, consider mid-1982 when the 1981–82 Recession did not end as expected. Chairman Volcker discerned a window of opportunity. Not only did Wall Street welcome his expansionary activism. Also, it approved of his ensuring that the recovery was a good one by risking some overdoing. When the expansion was assured, the Fed changed its tack. Doctrinaire monetarists condemned it for too much and too little. Eclectics who understand stabilization theory applaud ongoing corrections called for by new data.

I am not a pessimist who believes that we are in a vicious Kondratief down wave. I believe jobs can grow under prudent macro policies. I believe that cutbacks in President Clinton's fiscal-stimulus package should be the opportunity seized by the Federal Reserve for a pro-Investment rather than a pro-Consumption tilt to the U.S. GDP in this decade.

More than that, coordinating Federal Reserve monetary policy with austere Fiscal-Deficit reduction can be the single most important path for the 1990's, a needed corrective for the irresponsible 1980's.

Let me close with an important caveat. Leaning against the wind of inflationary overheating is a vital duty of the Federal Reserve as a central bank. It goes along with the Fed's vital duty to lean against the winds of self-aggravating recession. The hardest task ahead for an intelligent and responsible Federal Reserve will be to dis-

tinguish between *micro-caused* inflation—due to one-time supply shocks and tax changes—and *macro-caused* inflation, brought on by diminished slack in person-power and productive capacity.

On July 1, 1993, the weight of the evidence is against our economy as being one constrained by resource scarcity and on the verge of macro overheating. Later, when and if the weight of the evidence shifts, that will be the good time to pump gently on the brakes. That time is not now.

STATEMENT BY HENRY KAUFMAN

PRESIDENT, HENRY KAUFMAN & COMPANY, INC.

OPPORTUNITIES AND CHALLENGES CONFRONTING MONETARY POLICY

JULY 1, 1993

Mr. Chairman, I am pleased to accept your invitation to give my views on the conduct of monetary policy in the United States.

Over the most recent business cycle, monetary policy has had to contend with extraordinary economic and financial circumstances, which posed great challenges to the formulation and implementation of appropriate policies. Even now, with a moderate economic recovery under way, a number of unconventional elements continues to complicate this task. An unusually large number of business corporations and households has grown wary of debt and are trying to reduce their liabilities. Many financial institutions, which experienced a close brush with financial difficulty or saw their competitors narrowly evade adversity, have become more averse to taking risks in their lending and investing. Moreover, profound changes in the workings of our financial markets have had the largely unpredicted side-effect of severing what had been thought of as dependable linkages between the monetary aggregates and the behavior of the economy at large.

The implication of these developments is that our central bank no longer has a reliable measuring rod with which to calibrate monetary policy. It has no choice but to rely on judgment. Therefore, the issue at hand is how it should exercise judgment in the complex period ahead, when we can look forward to modest, but not dynamic, economic growth in the United States, a far more troubled economic and financial environment in Europe and Japan, and sometimes contradictory impulses acting on the rate of inflation.

Accomplishments of Monetary Policy during the Recent Cycle

The Federal Reserve presently has considerable latitude to exercise judgment, because its credibility has been enhanced by recent monetary policy accomplishments. It is worthwhile to take note of them:

First, interest rates have been lowered significantly. While it's possible to express misgivings about whether the Federal Reserve always pursued monetary accommodation with sufficient alacrity, it is undeniable that the central bank has managed to bring down short-term interest rates to around 3 percent, from over 10 percent in 1989 and 6 percent in April 1991 when the statisticians say the last recession ended. This slide in short-term interest rates has had a constructive effect on the long-term bond market, as well. By the beginning of this week, the yield on 30-year U.S. Treasury obligations, which is now the bellwether for the U.S. fixed-income markets, had declined below 6¾ percent, from over 9 percent in 1989 and 8¼ percent in April 1991.

To be sure, the decline in short-term rates exceeded that of intermediate and long-term rates by a large margin, producing an exceptionally steep, positively-sloped yield curve. But that positively-sloped yield curve has provided considerable benefits to the American economy and financial system. Specifically, it has helped in the financial rehabilitation of banks, savings and loans, and other financial institutions which had suffered from excessive lending to the troubled commercial real estate sector or to highly leveraged corporations. By taking advantage of the upwardly-sloped yield curve to make profitable investments without having to absorb additional credit risk, these institutions were able to repair their financial positions. Higher profitability permitted them to rebuild their capital ratios and regain access to the equity and bond markets, which had been all but closed to most financial institutions as recently as two years ago. The consequence has been to greatly reduce the number of actual and potential failures of financial institutions, requiring less of a call on the resources of the Federal deposit insurance funds, and ultimately less of a burden on taxpayers. Without the kind of interest rate decline that the Federal Reserve has instigated, we would be looking at a far more vulnerable financial sys-

tem, even less able to lend and invest than the one we have now. Accordingly, overall economic prospects would be far gloomier than they are.

Second, gradual declines in interest rates across the maturity spectrum have been supportive of large-scale bond issuance by corporations, by financial institutions, and by State and local governments. This has permitted the refinancing of higher cost existing debt, thereby lowering interest expenses. It has also been supportive of sizable issuance of new equity by large and small enterprises, which has reduced leverage and strengthened balance sheets. This outpouring of new issues of bonds and stocks would not have been possible without significant declines in interest rates.

Third, lower interest rates have been conducive to a record amount of refinancing of existing mortgages. This has allowed millions of homeowners to improve their financial positions, through a combination of lower interest payments and faster repayment of mortgage principal. As a result, over time the household sector will be able to be mores active as consumers and thus to contribute to economic growth.

Fourth, while it is true that monetary policy acts mainly on the short-end of the maturity spectrum, so that its impact on longer-term interest rates is largely indirect, it should be recognized that the Federal Reserve has encouraged the downtrend in longer-term interest rates more directly through useful modifications in the technical aspects of its open market operations. Specifically, from time to time over the past couple of years it has added permanent reserves to the banking system by acquiring sizable quantities of U.S. Treasury coupon issues, in addition to its periodic purchases of Treasury bills. As the following table shows, the Federal Reserve bought just $14 billion of U.S. Government obligations in 1990, of which 93 percent were Treasury bills and just 7 percent were in longer-dated securities. In 1991 and 1992, however, these purchases rose to $31 billion per year and by 1992 some 65 percent consisted of coupon issues. Especially noteworthy have been the sharp increases in the takedown of governments with maturities over 5 years, an increase that has accelerated so far this year.

FEDERAL RESERVE PURCHASES OF U.S. TREASURY OBLIGATIONS
$ Billions

			Coupons		
	Bills	Total	Less Than 5 Yrs.	Over 5 Years	Total
1989	-11.3	3.3	3.5	-0.2	-8.0
1990	13.1	1.0	2.7	-1.7	14.1
1991	19.0	12.0	10.1	1.9	31.0
1992	11.5	19.4	11.7	7.7	30.9
1993 (To Date)	7.0	8.1	3.1	5.0	15.1

SOURCE: Federal Reserve Bulletin

It should also be noted that the new financing initiatives undertaken by the U.S. Treasury this year will also tend to promote lower longer-term interest rates in the United States. Treasury has reduced the magnitude of new issuance of long-term bonds and has announced that it will cut back substantially on future 30-year bond issues by moving to two yearly auctions from four. This is a policy direction which I have long favored, not so much because it will reduce the Treasury's overall borrowing costs, but because it will open up opportunities for the private sector to issue debt for very long-term maturities. That will allow business corporations to make desirable longer-term commitments, augmenting their financial resources to fund additional plant and equipment expenditures, research and development activities, and other business expansion. It is notable that, in the past few months, Boeing, Conrail, and Ford Motor Credit have come to the market with non-callable 50-year bond issues, while Texaco has issued 50—year bonds non-callable for 20 years. These are rare events in the fixed-income markets, and it is heartening that they

were all well-received by investors. The modification in U.S. Treasury debt management practices is not the principal reason why these long-term issues were successfully brought to market, but it was helpful.

U.S. Economic Setting

Let me now turn to the outlook for the U.S. economy and for the inflation rate, which primarily sets the backdrop against which Federal Reserve monetary policy must be formulated. From my perspective, there is little likelihood of an imminent acceleration in the pace of business activity or pick-up in inflationary pressures that would justify an immediate tightening of monetary policy. All in all, we seem to be bottoming out cyclically in the inflation rate. In this context, the recent decision by the Federal Open Market Committee to adopt a so-called "asymmetrical directive" can be interpreted as an attempt to quiet inflationary expectations by reemphasizing the central bank's commitment to subdue inflation. But from a practical policy perspective, it was premature. The basic economic case for a move toward monetary restraint is not yet in place. I would draw your attention to the following factors:

First, while there are some elements of moderate strength in the business situation, notably demand for cars and light trucks and outlays for new business equipment, the manufacturing sector as a whole is not on solid footing yet. Durable goods orders are fading, and order backlogs are slipping. Lingering problems in manufacturing are especially evident with regard to job prospects. In contrast to an overall rise in payroll employment for the private business sector, employment in manufacturing has fallen this year, and surveys of business hiring intentions, such as the National Association of Purchasing Managers monthly report, indicate that more companies are planning to reduce staff than are planning to add to staff. I understand that there are some analysts who note that average weekly hours worked in manufacturing have climbed to near record levels and that this may be a precursor of new hiring.

I do not share that view. The relatively high figure for average weekly hours in manufacturing probably reflects a change in the composition of manufacturing employment due to corporate restructuring. Permanent layoffs of support personnel result in a diminishing proportion of salaried staff who work a shorter average work week and a commensurately higher proportion of hourly workers, who tend to have a longer average work week. Restructuring can be expected to have a lasting effect in lowering the number of jobs in manufacturing and perpetuating an unaccustomed frailty in labor markets in the United States.

Second, as I mentioned, business investment spending on new equipment has been a relatively strong component of gross domestic product (GDP) over the past several quarters. But its continuation is now questionable in view of the withdrawal of the proposed incremental investment tax credit. Defense-related capital goods orders are conspicuously weak, reflecting the continuing downsizing of the military, but even orders for non-defense capital goods are languishing.

Third, U.S. export prospects are diminishing. That is because of the continuing slowdown in the European economies, the extraordinary economic and political uncertainties in Japan, and the increasing degree of international competition in Asian and Latin American markets. I will return to the question of how serious is the economic malaise in the other industrial countries later in my statement. For now, I merely want to stress that merchandise exports cannot be counted on as an important source of stimulus for our domestic economy as long as the economic growth of our main competitors abroad remains inert.

Taking these factors together, I see little danger that manufacturing output will increase so rapidly in the coming months as to raise the rate of capacity utilization, depicted in Figure 1 in the attached Appendix, to a level that would bring about a pronounced acceleration of inflation.

Fourth, even outside the manufacturing sector, which accounts for only about one-fifth of total employment, the American labor market remains quite soft, notwithstanding the slight pick-up in private sector employment this year. The growth in payroll employment still lags well behind that in previous business expansions, and there seems to be a growing concentration of joblessness among higher pay groups, such as middle management personnel and professional staff. Newly-graduated college students and others leaving school report exceptional difficulty attaining suitable employment. Thus, it is highly likely that the subdued wage and compensation behavior, as shown in Appendix Figure 2, will continue to retard inflation.

Fifth, there are still formidable drags on economic activity stemming from the overbuilding of commercial real estate and the financial consequences of excessive lending to this area. Real estate values continue to fall in important regional markets, most notably southern California, and new commercial building remains de-

pressed in many areas of the country. No amount of jaw-boning by officials in Washington will change the economic reality that real estate development must endure a long period of adjustment before effective demand is brought back into conformity with overbuilt supply.

Sixth, homebuilding has moved ahead, particularly of single-family houses, but the increase in home construction is lagging well below cyclical dimensions. There is little likelihood of a surge in fresh housing-related credit demand, as distinct from mortgage refinancing that generates little net new credit demand, that could pressure credit markets any time soon.

Seventh, indeed, there is little evidence of a general rise in net credit demands almost anywhere in the economy. As shown in Appendix Figures 3 and 4, neither overall commercial bank lending nor short-term business credit (which includes commercial and industrial loans made by banks plus non-financial commercial paper) has demonstrated sustained-growth over recent months. Why is this important? Because it shows that business is staying within itself. Businesses are able to finance virtually all contemplated activities, including work in progress, inventories, and planned plant and equipment expenditures, from internally-generated funds. It also suggests a relative paucity of new risk-taking ventures requiring debt finance. While this caution is probably compatible with the continuation of moderate economic growth, it is hardly an early precursor of either a robust expansion of business activity or of a substantial lift in the rate of inflation.

Eighth, recent behavior of the monetary aggregates, while erratic, is not suggestive of an inflationary break-out. The growth of the targeted monetary supply, M2, remains well below the lower boundary of the Federal Reserve's target band. During the past several weeks, there has been a spurt in the growth of transactions balances, but these possibly reflect problems associated with seasonally adjusting tax payments and with accounting for the monetary consequences of the bulge in mortgage refinancing. In addition, there have been large increases in currency in circulation, which quite likely reflect the expanding use of U.S. dollars in areas of the world wrestling with political or economic instability, such as the former Soviet Republics. These factors have been responsible for the more rapid growth in M1, the narrowly defined version of the money supply. But I doubt that much of this growth signifies sharply increased spending intentions by consumers and businesses here in the United States. The central bank has de-emphasized the importance of the monetary aggregates, and that seems appropriate to me.

Ninth, world commodity prices are weak. Far more important than the price of gold or some other precious metal, which the media likes to dwell on, is the price of oil. The price of benchmark West Texas Intermediate has fallen to $18.60 a barrel, as shown in Appendix Figure 5. A year ago it was $22.50. Other important commodity prices are also quite depressed; the Journal of Commerce commodity price index, shown in Appendix Figure 6, has slipped back sharply after a temporary rise early this year. Generally soft commodity prices are a result of the global economic slowdown, which is a powerful factor in suppressing worldwide inflation, and eventually will be decisive in lowering world interest rates.

U.S. Fiscal Policy

Monetary policy is not made in isolation; obviously, the evolution of U.S. fiscal policy has critical importance for the central bank. Let me briefly make three general comments about the fiscal outlook that I believe are particularly relevant for the conduct of monetary policy.

First, as the Clinton Administration's budgetary proposals make their way through the Congressional approval process, it is evident that fiscal policy will likely produce little or no near-term stimulus to the economy and, on balance, may have a modestly restrictive cast. For monetary policy, the fiscal year 1994 budget as it is now shaping up should not pose any problem and, in fact, appears to be compatible with the continuation of monetary accommodation.

Second, the emerging medium-term fiscal approach depends more on tax and other revenue increases to achieve budgetary restraint than on spending reductions. In addition, the higher taxes are front-loaded in time, while the spending reductions incorporated in the program are back-loaded. For the financial markets, the problem is naturally the danger of backsliding on intended spending cuts in the outer years. Therefore, financial market participants will be eager to see whether the Congress is going to be resolute in assuring that those intended reductions are tamper proof. There is a strong case for explicit mechanisms within the scope of the budget authorization to make them tamper proof. The Federal Reserve would probably welcome this as much as the market.

Third, I subscribe to the view that meaningful budgetary control over the long term is not possible without a reasonable amount of tax increases. Reducing the deficit solely from spending cuts is probably not acceptable nor is it desirable. Critics sometimes lose sight of the fact that to those people whose benefits are cut, that cut is the economic equivalent of a rise in taxes. But I want to urge caution on the composition of tax increases, because there is a dark side to nearly every tax. Many kinds of taxes are inherently inflationary, and it would be wise to proceed with great care when contemplating imposing any of them. I emphasize this point because it would be a great disappointment—as well as a source of public disillusionment—if our Government went through the painful process of coming to grips with our vexing budget deficit problems only to fail to secure the hoped-for benefits of improved economic performance and lower real interest rates. That disappointment could easily happen if the imposition of new taxes turned out to really worsen inflation, since a significant rise in the inflation rate would have to be factored in by the Federal Reserve in its monetary policy decisions.

Economic and Financial Conditions in Major Industrial Countries

I now want to comment on the international economic and financial landscape and its implications for U.S. monetary policy. For a variety of reasons, the global economy is not doing well, and prospects for an early rebound are dim. Some of the impediments to satisfactory economic revival are specific to individual countries. Thus, like the United States, the United Kingdom also has to contend with a shrinking defense sector and with the legacy of vastly overbuilt commercial real estate. Its recovery from a long recession has been shallow. Germany has to deal with the unprecedented challenge and heavy budgetary expense of integrating a territory with an entirely alien economic and financial culture into a modern competitive state. The upshot has been unacceptably high inflation, stringent monetary policy to bring it down, and a deep recession. Italy has to restore business and consumer confidence in the wake of extraordinary political events. Japan has to surmount the formidable economic, financial, political, and psychological consequences of the bursting of an overinflated speculative bubble, the emergence of a U.S.-style recession, and now the break-up of decades-old modalities of governance.

But putting aside the differences, there is a distinctive common thread running through the restrained economic prospects of the major industrial countries. In a nutshell, except for Japan, fiscal policy in the usual cyclical sense is inoperative, while monetary policy is encumbered everywhere.

Fiscal policy is inoperative as a practical matter in Europe because of large budgetary deficits that have been built up at all levels of government. It is indisputable that, despite the widespread slump in European business activity, the inclination is toward greater fiscal restraint. The German government is considering ways of bringing its deficit under better control. The overall deficit, including Germany's federal, state, and local governments, has been swollen by huge subsidies to the new eastern states, and lately by the recession, to an estimated 5 percent of GDP this year. When the deficits of state-run enterprises, like the railways, are added in, the deficit swells even further, to the neighborhood of 8 percent. In France, the overall public sector deficit is likely to approach nearly 6 percent of GDP, and the new government in France is pressing ahead with plans for fiscal retrenchment through a combination of revenue increases and expenditure restraints. Following the remarkable referendum of April, Italy also has a new government which is faced with a towering public sector deficit in the vicinity of 10 percent of GDP and which is firmly committed to achieving a significant reduction. And governments in many other European countries are also seeking to pare spending, and not to launch stimulative programs. Most Europeans believe the government commands too large a portion of economic resources and are reluctant to see that share expand, even for the stated purpose of stimulating economic recovery.

Only Japan has any scope for a significant fiscal expansion. But no one knows how political forces will shake out following the impending general election or whether the stubborn resistance to meaningful tax cuts on the part of powerful segments of the previous government hierarchy and the ongoing bureaucracy will be shaken. This leaves the bulk of the proposed fiscal expansion in the area of public works expenditures, which are notoriously hard to put into effect in a timely and efficient manner, especially at a time of political uncertainty. It would not be surprising if the actual stimulative impact for the first year of the program turned out to be below the magnitudes initially outlined by the Japanese government.

Challenges Confronting Monetary Policy

By default, therefore, it is monetary policy that has been left with the full burden of reviving the industrial economies of Europe, as it has in the United States, and monetary accommodation still has a critical role to play in Japan as well. This is not all bad. Monetary policy has the great advantage of flexibility and reversibility. Implementation can be modulated, depending upon the evolution of business activity. More important, monetary accommodation can be put on hold or even reversed once conditions in the economy start to pick up some momentum. Fiscal policy is a cruder instrument.

But throughout the industrial world monetary policy is encumbered. There are four reasons for this.

First, a number of factors inhibiting an adequate economic rebound are of greater than cyclical dimension. The downsizing of the military is one. Restructuring is another. Pressure to restructure is spreading from North America to Europe and to Japan, as an increasing number of corporations recognize that they are operating in a far more competitive marketplace than in the past and have no choice but to cut costs forcefully. This process leads more businesses to outsource, to manufacture and even to provide services where labor costs are low. The capacity to do this has vastly improved with cheaper and more technologically advanced transport and communications networks, the lifting of political barriers, and the emergence of large new trading blocs. These developments have also encouraged labor in economically distressed and in impoverished parts of the world to become more mobile. Millions of people have thronged into western Europe to improve their economic lot, and more hope to migrate. This will have a profound impact in keeping labor costs lower than they otherwise would be, limiting the bargaining power of organized labor, and fostering certain forms of social unease. How is monetary policy to respond to these developments? There is no historical parallel to serve as a guide.

Second is widespread financial impairment. In many of the key industrial countries financial institutions which had participated in the excessive lending to commercial real estate or highly leveraged companies in the previous expansion are still disabled. Even those which have been able to improve their profitability, their capital ratios, and their overall financial health are not eager lenders. Managements are chastened. Lending officers are mindful of the criticism they received and have seen their lending authority cut back. There is little evidence of financial institutions seeking actively to expand their lending they are content to sit back and wait for borrowers to appear. But judging from our experience so far in the United States, borrowers are more interested in curbing outstanding indebtedness than incurring new debt. Here again, to deal effectively with this problem, the monetary authorities cannot rely primarily on cyclical monetary analysis.

Third, the much more deregulated financial markets we now have also tend to make it more difficult to gauge the effect of any stated degree of monetary accommodation. While the process of deregulation has proceeded unevenly and imperfectly both within and across nations, the common feature is that there is far less segmentation of credit markets. There are also far fewer protected market niches which, in the old days, used to more or less guarantee a dependable stream of earnings to different types of financial institutions. What this means is that backs and other financial institutions are more inclined to increase profits without taking additional credit risk in order to improve their overall financial conditions. As a result, wherever a steeply positively sloped yield curve has emerged—the customary symptom of an accommodative monetary policy—banks and other financial institutions have stepped up their acquisitions of marketable securities, particularly government obligations, in what started out as a cyclical response. But this reaction seems to go farther and last longer than in previous interest rate cycles. Under these circumstances, we do not know what level of interest rates below today's levels will ignite dynamic credit creation.

Fourth, central bank attitudes may also constrict the potential stimulative impact of monetary policy. Central bankers remember earlier periods when monetary accommodation was overdone, and inflationary pressures were effectively validated. They do not want to repeat that mistake. They are also mindful of the sensitivity of the bond markets to any hint of renewed inflation. In a world in which the average unemployment rate in Europe is in double digits, yet inflation rates relative to unemployment remain high in many countries, this is no idle concern. Central banks are thus inclined to err on the side of caution in bringing about lower short-term interest rates.

Monetary Policy Options

The essence of the policy dilemma in dealing with the global economic and financial situation is that fiscal stimulation is generally not feasible, considering the budget deficits already in place, but that the central banks of the major industrial countries are hesitant to exercise stronger leadership. The need is for a coordinated effort on the part of the major central banks to bring down world interest rates, but naturally central bankers don't want to leave the impression that they have abandoned their fight against inflation. So they are inclined to hold back, rather than to take the lead.

How much help would bolder monetary policy be at the present time? In my judgment, a great deal. With the credit creation process still moribund, coordinated monetary accommodation would make a valuable contribution to invigorating growth and would be an acceptable risk to take. In fact, the bigger risk would be for central banks to temporize in deference to the conventional argument that more determined monetary easing would disturb the financial markets. Under current conditions of extensive corporate restructuring, widespread softness in labor markets, and mild growth in money and credit, financial markets would readily accept additional monetary accommodation and would not construe it to be necessarily inflationary. By contrast, far more disturbing to the markets would be a breakdown in the process of international economic cooperation and in the liberal trading system that lies at the heart of the process. Such a development, by threatening a progression of trade restrictions and retaliatory counter-restrictions, would carry with it the true danger of an escalation of world inflation.

I am aware that there is an element of risk in moving in the direction of a greater monetary accommodation. But there is a greater risk in standing aside and essentially acquiescing to inward-looking trade policies. The question is: Which is the more acceptable risk under current economic and financial conditions? My position is that central banks should use the flexibility they have to bring down interest rates, but be prepared to bring rates back up expeditiously when economic activity responds and the inflation rate begins to show signs of a more pronounced lift. Ultimately, this means being prepared to reject the inevitable criticism, whether from politicians or the business community, of *any* move toward restraint.

Implications for Federal Reserve Monetary Policy

The policy challenge facing the Federal Reserve differs from that of most other major central banks in that unlike other countries the United States has entered a business recovery, albeit a moderate one, and has to weigh what is needed to sustain economic expansion against what is desirable for continuing downward pressure on the rate of inflation.

I believe that in the global context that I have described the Federal Reserve should be able to pursue these joint objectives for at least the time being by maintaining the present degree of monetary accommodation. It may also find the opportunity of taking advantage of the coming global de-escalation in interest rates to edge the Federal funds rate somewhat lower, particularly if the U.S. dollar continues to display the kind of strength in the foreign exchange markets that it has in recent days. By following this policy course, the central bank will retain the flexibility to react to a change in economic conditions, in particular a more pronounced lift in the rate of inflation.

What I do not favor is a preemptive move toward restraint on the pretext that this would somehow shore up the Federal Reserve's "credibility" in the financial markets and in so doing relax market concerns about inflation prospects. I have great doubts about conditioning policy on something as ill-defined as the notion of "credibility." It is a policy argument that has an unfortunate tone of self-righteousness, rather than a firm analytical grounding. As a policy position, it is especially bizarre at the present time when, if anything, the financial markets have shown themselves to be quite comfortable with the overall stance of monetary policy. The best evidence of this is displayed in the yield curve, which has become notably flatter this year. For example, the spread between the yield on 3-month Treasury bills and the yield on 30-year Treasury bonds has diminished from 440 basis points in January to about 355 basis point this week. This is suggestive of a mild lessening in long-term inflationary expectations, even as the Federal Reserve has pursued a steady policy of monetary accommodation.

I also reject the proposition that a modest rise in the level of the Federal funds rate would have little significance for the economy and so that such a preemptive move by the Federal Reserve would be costless. To the contrary, a higher Federal funds rate would translate into higher interest payments by businesses and households, specifically those with adjustable rate mortgages, a higher dollar in the for-

eign exchange markets, and some downward pressure on share prices. All would weaken growth prospects.

I also take issue with the assertion that a small increase in the Federal funds rate this summer would be welcomed by the financial markets and would accordingly lead to a decline in bond yields. Perhaps. But equally likely is that the bond market would interpret such a rise in the Federal funds rate as the first of a number of future increases, and market participants might easily react by pushing bond yields higher. Maybe such a preemptive move would reassure the financial markets that the central bank was determined to quell inflation and so would reduce inflationary expectations. But it is equally likely that the market would suspect that the Federal Reserve was in possession of information not-yet publicly disclosed, indicating the upcoming inflation news was going to be sour. Under that scenario, the rise in the Federal funds date could magnify inflationary expectations, precipitating a sell-off of bonds.

A more systematic analysis of the present inflationary potential within the U.S. economy does not justify either exaggerated inflationary expectations or a preemptive tightening by the Federal Reserve. Inflation as depicted in the most commonly watched measure, the consumer price index, is exaggerating actual price pressures. Inflation is not found in the business community, and it is not revealed in speculative activity in the great majority of product markets. There is no evidence whatsoever of a surge in credit demand on the part of those wishing to finance speculative holdings of inventories, commodities, or real estate, in contrast to the conditions that prevailed during the previous run-up in the rate of inflation in the late 1970's. There is no evidence of a tightening in labor markets that would presage an escalation of wage settlements. To the contrary, as I have detailed, labor markets are soft. And if we look at the stock market, we see a rather nondescript pattern, with the market as a whole holding within a rather narrow trading range, but with the shares of individual companies susceptible to heavy punishment when earnings turn out to be less than what had been hoped for. This is not symptomatic of a business setting characterized by generalized inflation.

The time will come—no one knows precisely when, perhaps in 1994, perhaps not until 1995 or 1996—when the business recovery will have matured, excess capacity will have been worked off, labor markets will have become tauter, the economic recovery abroad will have begun, commodity prices will have turned higher across the board, real estate prices will have firmed, and credit demands will have become conspicuously stronger. Then, we will want the Federal Reserve to act with dispatch and determination to resist forcibly any build-up of inflationary pressures. But none of those circumstances prevail today.

APPENDIX

Figure 1.

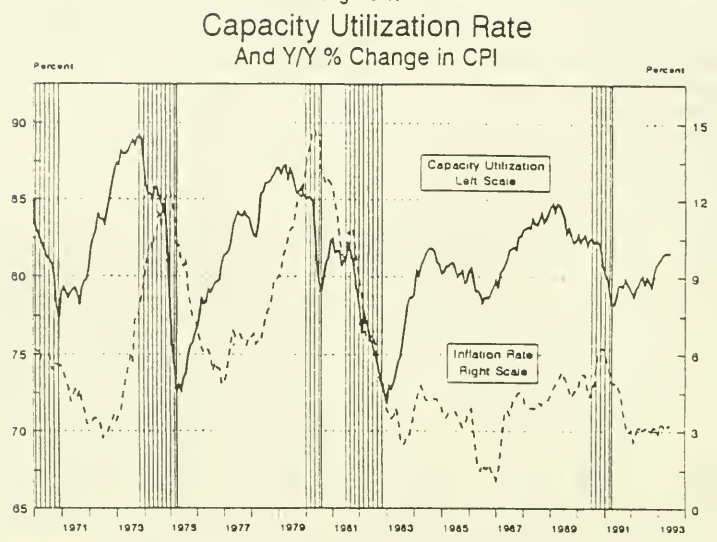

Figure 2.

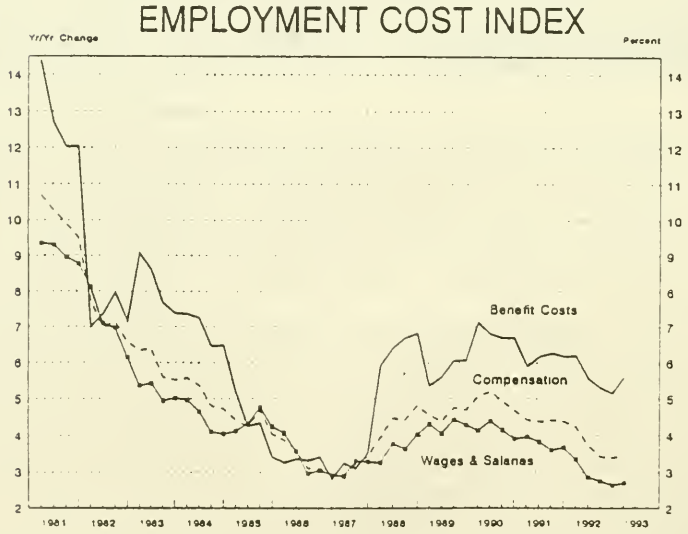

Figure 3.

LOANS AND SECURITIES AT ALL COMMERCIAL BANKS

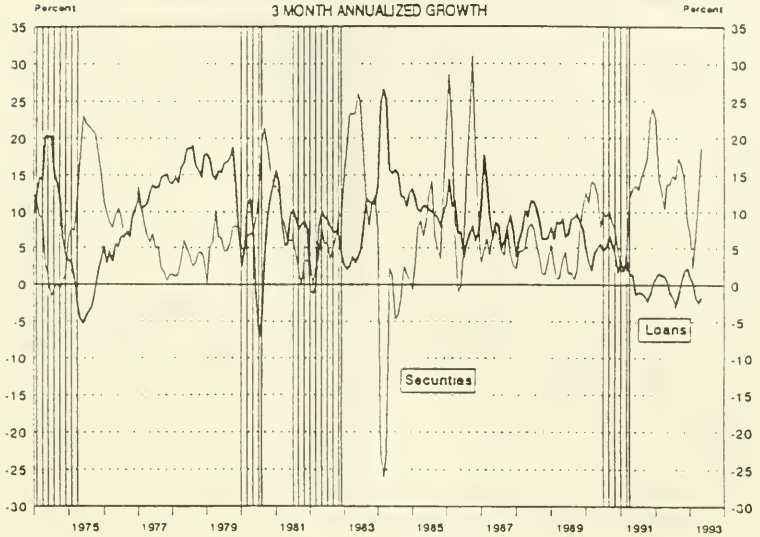

Figure 4.

SHORT TERM BUSINESS BORROWING

C &I LOANS + NONFINANCIAL COMMERCIAL PAPER

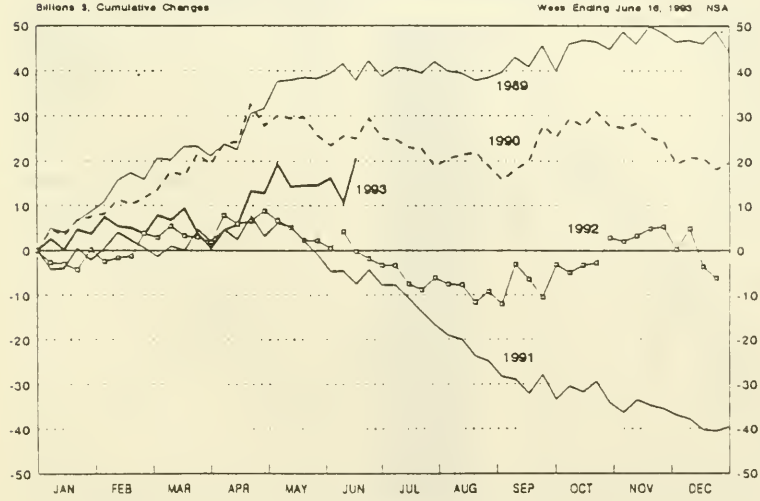

Figure 5.

WEST TEXAS INTERMEDIATE CRUDE

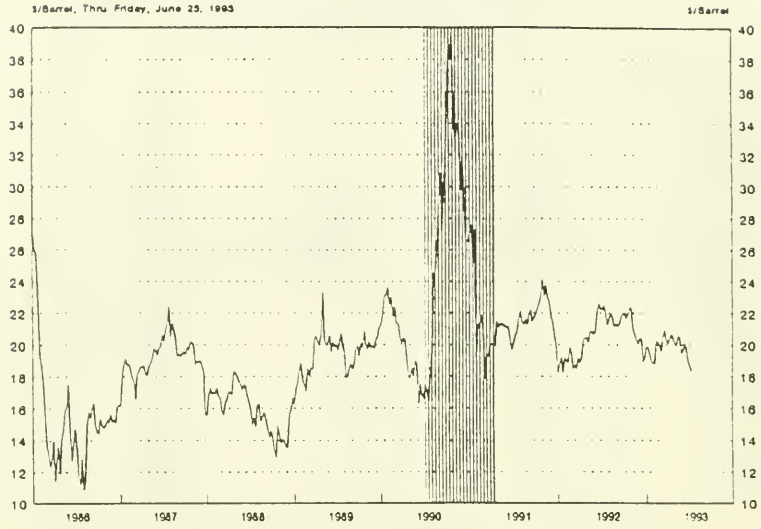

Figure 6.

JOC COMMODITY PRICE INDEX

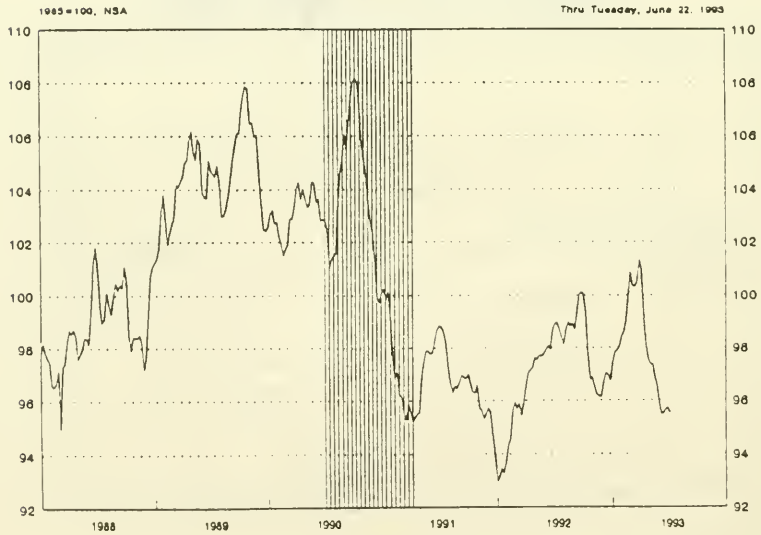

Figure 7.

REAL GDP GROWTH

Average Annual % Change

	1992:3Q – 1993:1Q	Prior 5 Years 1988 – 1992:2Q	Previous 20 Years 1968 – 1987
United States	3.26	1.25	2.68
Japan*	–0.10	5.44	5.13
Germany	–3.10	*3.45	*2.67
France	–1.00	2.65	2.75
Italy	–1.50	2.37	3.38
United Kingdom	1.00	0.48	2.47
Canada	2.50	0.75	4.07

Source: International Financial Statistics, IMF

* Gross National Product.

Figure 8.

INDUSTRIAL PRODUCTION

Average Annual % Change

	1992:3Q – 1993:1Q	Prior 5 Years 1988 – 1992:2Q	Previous 20 Years 1968 – 1987
United States	3.74	1.21	2.96
Japan	–6.58	3.95	5.58
Germany	–8.05	3.46	2.84
France	–2.73	2.03	2.90
Italy	–3.47	1.77	2.93
United Kingdom	1.00	0.02	1.80
Canada	3.15	–0.64	3.46

Figure 9.

INFLATION

Average Annual % Change in CPI

	1992:3Q – 1993:1Q	Prior 5 Years 1988 – 1992:2Q	Previous 20 Years 1968 – 1987
United States	3.15	4.38	6.35
Japan	1.15	2.26	6.21
Germany	4.07	2.79	3.85
France	2.18	3.14	8.34
Italy	4.53	5.93	11.62
United Kingdom	2.29	6.53	9.90
Canada	1.92	4.31	6.93

Figure 10.

10 YEAR GOVERNMENT BOND YIELDS

Period Average

	1992:3Q – 1993:1Q	Prior 5 Years 1988 – 1992:2Q	Previous 20 Years 1968 – 1987
United States	6.55	8.32	8.80
Japan	4.37	5.76	7.32
Germany	7.39	7.73	7.75
France	8.35	9.15	10.09
Italy	11.88	10.64	12.32
United Kingdom	8.90	9.91	11.45
Canada	8.40	10.07	9.82

Source: International Financial Statistics, IMF

RESPONSE TO WRITTEN QUESTIONS OF SENATOR RIEGLE FROM HENRY KAUFMAN

Q.1. We are working now to lower our budget deficits, something that foreign countries have strongly encouraged in the past. Both of you appear to be suggesting that we should now be asking other countries to lower their interest rates. How far do you think German and Japanese authorities should lower rates, and how much might we benefit?

A.1. The situation is somewhat different for Germany and Japan. Germany is suffering a deep recession. This is largely traceable to two causes: an unsustainable investment boom in the former West Germany, in part due to overoptimistic estimates of the near-term benefits of European economic integration, and the costly public subsidies to the former East Germany to enable it to make the great leap from a backward, inefficient Communist state to a modern industrial society. These factors led to a surge in money and credit expansion and to an acceleration of inflation, which the Bundesbank sought to reverse through an austere monetary policy. That policy is working in the conventional way. Business activity has contracted. Credit expansion is beginning to slow. And inflation is gradually cooling off. Now the Bundesbank must change priorities in order to avoid overdoing restraint, with all the adverse economic and social consequences that would foster.

The German central bank has the latitude to bring down short-term market interest rates by at least 2 percent over the next half year or so, from just below 7½ percent at present to the range of 5½ percent to 6 percent. Such a de-escalation of interest rates will permit other European central banks to follow in whole or in part, setting the stage for some recovery of business activity throughout the Continent in 1994 and, more noticeably, in 1995.

We will directly benefit from higher export sales and from higher earnings of those U.S. corporations that have long-standing and extensive business operations in Europe. We will indirectly benefit in so far as reduced interest rates in Germany and the rest of Europe allow interest rates here to be lower than they otherwise would be.

In Japan, the economic slowdown was a reaction to past speculative extravagance fed by excessive credit creation. Business investment got out of line with plausible demand. Stock market prices were drive up to unsustainable levels. Debt-financed speculative purchases of commercial real estate produced outlandish values. The Bank of Japan responded with a restrictive monetary policy, and the subsequent stock market crash, plunge in real estate prices, and fall-off of business investment has left serious financial and economic casualties. Statistically, the Japanese business recession is bottoming out, and there is a good chance that the relaxation of monetary policy that has already taken place plus the stimulative fiscal policy measures adopted by the outgoing Japanese government will encourage a modest recovery by 1994.

But the financial legacy of speculative excesses remains, and therefore monetary policy can play a still more constructive role in dealing with impediments to economic and financial rehabilitation in Japan. Accordingly, hope to see the Japanese authorities reinforce fiscal stimulus by lowering short-term interest rates by a further 0.5 percent (50 basis points) over the next few months, a de-

cline that will be largely mirrored in longer-term interest rates, as well. This will hasten the repair of financial positions of companies and financial institutions and help to support domestic demand. In time, this will begin to curb the Japanese trade surplus so that American and other producers will sell more to Japan.

Q.2. The Fed has had increasing difficulty interpreting its various monetary aggregates in recent years, to the point that the Fed appears to ignore them almost completely. Mr. Kaufman's testimony says that is appropriate. But if the Fed is not targeting monetary aggregates, what should they be targeting, and on what basis should we judge their success or failure?

A.2. The Fed's traditional joint objectives are to achieve sustainable economic growth and to keep inflationary pressures in check. For relatively brief time periods, it has been able to successfully use the monetary aggregates as intermediate targets. This simply means that by following a money target more or less mechanically, the Fed could be reasonably confident that it would also achieve a satisfactory outcome in terms of growth and inflation. Much of the time, however, the monetary aggregates have been unreliable. Either different versions of the money supply gave off different signals, as in the past year or so, or no version of the money supply had a dependable link to ultimate economic objectives. In these periods, as now, the Fed has had to use judgment, taking into consideration a wide range of indicators other than the monetary aggregates. Those other indicators include, among others: the growth of credit, the debt ratios of the private sector, the level of interest rates, the financial positions of corporations and financial institutions, the prices of equities, the net worth of the household sector, and the value of the dollar in the foreign exchange markets. I would not recommend formal targets for any of these factors, but all are important for income determination, spending, and investment behavior.

It seems to me that the Congress ought to be evaluating the conduct of monetary policy on a medium-term basis, not on the basis of short-term fluctuations in economic activity. It should be asking Fed officials to discuss the relationship between the actual and potential growth of the economy and the evolution of the inflation rate over two to three year time periods, not over one or two quarters. Monetary policy is a success when actual and potential growth are reasonably aligned over such a time period, while the rate of inflation is gradually diminishing. The Congress should also focus on the financial health of the private sector and of financial institutions, for economic growth financed in an inherently risky manner is not going to be sustainable. Part of the Fed's responsibility is for the safety and soundness of the financial system, and it should be accountable for any serious breaches in the underlying condition of the financial system.

Q.3. On the face of it, the budget policy we are currently implementing over the next few years appears to be quite contractionary. Chairman Greenspan has argued that he believes it will not prove to be because it will significantly lower interest rates enough to effectively offset most or all of the contractionary impetus. What is your view?

A.3. There is a close relationship between the ratio of Treasury debt held by the private sector to GDP, on the one hand, and real interest rates, on the other. Broadly speaking, the larger the amount of Government debt the private sector has to absorb, the higher real interest rates have to be in order to induce investors to hold that debt. Therefore, significant cuts in the magnitude of the Government's budgetary deficit will reduce the net amounts the Treasury must borrow and other things equal will encourage a decline in real interest rates. Lower real interest rates tend to stimulate investment, both by business corporations and State and local governments, as well as residential homebuilding, thereby offsetting some portion of the contractionary impetus of a lower budgetary deficit.

What I have just laid out is relatively standard. Ultimately, the fundamental reason why it is wise policy to cut the budgetary deficit is that it will strengthen confidence in the private sector and provide a more stable framework for longer-term decisions about investment, research and development, and business expansion. In short, it will support a rechanneling of resources into endeavors that will raise productivity and living standards.

Q.4. In recent years, high debt levels of households and businesses, and increased integration of the world's financial markets have led some to question the ability of the Fed to have a significant impact on the pace of the recovery. In your judgment, how much power does the Fed really have to stimulate the economy?

A.4. I believe that generally speaking Fed has very considerable power to influence economic activity, although naturally its influence is indirect and therefore imprecise. But as I pointed out in my prepared statement, the effectiveness of monetary policy everywhere, not just in the United States, is impaired by the special financial problems of recent years. Therefore, I have long felt that it would take substantially lower short-term interest rates than would have been predicted from a conventional review of past statistical relationships to ignite a solid recovery. That has turned out to be the case in the United States, and it is equally evident that lower interest rates are needed abroad to revive other major industrial economies.

RESPONSE TO WRITTEN QUESTIONS OF SENATOR RIEGLE FROM PAUL SAMUELSON

Q.1. We are working now to lower our budget deficits, something that foreign countries have strongly encouraged in the past. Both of you appear to be suggesting that we should now be asking other countries to lower their interest rates. How far do you think German and Japanese authorities should lower rates, and how much might we benefit?

A.1. America should seek to attain all or most of its needed short-term macro stimulus from Federal Reserve credit expansion, for the reason that since 1981 our society has been on a consumption binge (private and public). Consequently, to address the deficiency of adequate domestic capital formation owned by Americans, for us the optimal stimulus mix involves budgetary austerity and compensating stimulative Fed policy.

For Japan, which is a high-saving society with austere fiscal stance, our recommended advice ought to involve a larger recourse to deficit *fiscal* finance and less reliance on (a) balance-of-payments surplus for stimulus, and relatively less reliance on Bank of Japan credit stimulus. That kind of stimulus would tend to make investment in yen assets less attractive, thereby slowing down the appreciation of the yen needed to better balance Japan's bilateral and multilateral current accounts. (Some Bank of Japan easing is not precluded; still the prime stimulus should be fiscal.)

For Germany and the EC nations generally, *both* forms of macro stimulus are needed—in their own interest to tackle double-digit unemployment rates and slumping production, and in the interest of having European locomotives join in with the American locomotive to ameliorate the 1990–93 global recession.

Q.2. The Fed has had increasing difficulty interpreting its various monetary aggregates in recent years, to the point that the Fed appears to ignore them almost completely. Mr. Kaufman's testimony says that is appropriate. But if the Fed is not targeting monetary aggregates, what should they be targeting, and on what basis should we judge their success or failure?

A.2. In my reading of economic history and macroeconomic principle, it is never sufficient to build monetary policy on the basis of targets for one or several of M_1, M_2, or M_3 aggregates. I agree with Henry Kaufman that particularly since 1980 reliance on M-targeting has produced and will yield erratic Fed actions. Behavior of the aggregates should be but one of several eclectic criteria for best achievable policy of leaning against the winds of both adverse production trends and adverse price-level trends. Stabilizing nominal GDP growth at the approximate growth potential of the economy, plus allowance for the residual price-level inflation that can be prudently curtailed only over a period of years, that criterion has an approximate and pragmatic role to play. However, in time of exogenous "supply shocks," and when public policy may bring once-and-for-all *micro* shocks to the price level (as from a new energy tax or a one-time step up in payroll taxes for medical care), then a delicate compromise between adjusting Fed policy to take partial account of such shocks and between non-accommodating policy will be called for. There is no magic fine-tuning formula that can be decided on and announced to hold for the future. Always, the Fed needs to judge and balance the divergent trends of output strengths and of price-level overheatings. After 1989, this Fed has shown non-optimal bias toward preoccupation with ephemeral inflation accelerations. Central banks abroad—Germany and Japan—have been even more biassed.

One holds the Fed accountable for under stimulus in 1929–33 and 1990–93, and for over stimulus in, say 1972–73. Always one asks: Is the Central Bank making informed and responsible judgments about the levels and changes in manpower resources, in degrees of under-capacity operation, and in self-aggravating heatings up of the price level? The *Bundesbank* notion that its one concern is price level stability and that it is an independent Fourth Estate of Government has spread much mischief, around the world and in Germany itself.

Q.3. On the face of it, the budget policy we are currently implementing over the next few years appears to be quite contractionary. Chairman Greenspan has argued that he believes it will not prove to be because it will significantly lower interest rates enough to effectively offset most or all of the contractionary impetus. What is your view?

A.3. Economic history—in 1865–95 America, 1929–35 global economies, 1990–93 America and the OECD economies generally—make it doubtful that Chairman Alan Greenspan is correct to believe that *laissez faire* money markets will spontaneously equilibrate interest rates to offset any macro drag from (a) post-cold war contraction of defense industries, (b) post-1980's restructuring of American industries after an era of debt-leveraging, and (c) rapid strides abroad in competitive power to undermine many American sectors that used to possess comparative advantage in international trade.

What the American Nation needs from Dr. Greenspan and his colleagues is a *credible* assurance like the following:

> Without relaxing our vigilance and determination to act to offset significant macro-induced overheating of the U.S. economy, your Central Bank can be counted on to act to offset and compensate for depressing effects of foreign commerce, bank liquidity, industrial and defense restructuring, fiscal-policy austerities for the long run and gridlocks for the short run. The potency of monetary and credit weapons has not been used up, and the expansions that we would welcome if spontaneously occurring are not superior to expansions of the same macro strength brought about by our prudent credit stimuli. When America is in special need of private capital formation domestically owned, we perceive a special role and importance for credit policies and we agree that it would be a self-inflicted wound if America permitted austerity pressure on consuming to release resources from production to unemployment and excess capacities rather than effectively to capital formation and prudently-high employment.

Q.4. In recent years, high debt levels of households and businesses, and increased integration of the world's financial markets have led some to question the ability of the Fed to have a significant impact on the pact of the recovery. In your judgment, how much power does the Fed really have to stimulate the economy?

A.4. The many interest rate reductions achieved and/or tolerated by the Fed since 1990, although they have repeatedly been too little and too late, have had remarkably good effects on the U.S. economy. But for them, our banks and real estate markets would now be in shambles; but for them the construction industry and durable goods spending would still be in the doldrums and our 7 percent unemployment rate would be knocking on the two-digit doors of European unemployment rates. The present evidence, in comparison with 1930 or 1932 or 1938, argues strongly that the Fed will *not* (repeat *not*) "be pushing on a string." Nor will it be the case where "you can lead the horses to the tank of ampler credit, but you can't make them drink." In time of recession or prolonged weakness in a recovery, the authorities should not hesitate to contrive or countenance *negative* short-term *real* interest rates if expe-

rience reveals that such are needed to induce greater private capital formation.

The Fed is not omnipotent. It lacks power and wisdom to "fine tune" perpetual prosperity with zero price inflation. But its potential powers are still, on the evidence, vast if deployed with vigor. The free-market facts of life put squarely on the shoulders of the Federal Reserve the responsibility to lean against the prevailing winds of macro misbehavior.

Once the 1993–95 recovery is solidly assured, I will expect to join with other modern economists in testifying before Congressional Committees the desirability and necessity for Federal Reserve austerity to keep under optimal control the vigor and attained-growth of the mid-decade American economy.

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